HOW MUCH ARE AMERICANS AT RISK UNTIL CONGRESS PASSES TERRORISM INSURANCE PROTECTION?

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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HOW MUCH ARE AMERICANS AT RISK UNTIL CONGRESS PASSES TERRORISM INSURANCE PROTECTION?

WEDNESDAY, FEBRUARY 27, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 3:35 p.m. in room 2128, Rayburn House Office Building, Hon. Sue W. Kelly, [chairwoman of the subcommittee], presiding.

Present: Chairwoman Kelly; Representatives Weldon, Biggert, Ney, Tiberi, Gutierrez, Inslee, and Maloney of NY.

Chairwoman KELLY. First of all I want to apologize to all of you for the delay here. There is an unusual floor proceeding going on and I had heard that we had a vote. About 20 minutes ago I heard there was a vote in 5 minutes. And I thought, well, we will just wait that 5 minutes and that would save everybody time.

They are still arguing on the floor. So when they get that argument over, we will go back and we will have to vote during this hearing.

But that being said, I want to thank you all for your patience and this hearing of the Subcommittee on Oversight and Investigations will come to order.

I want to thank all Members of Congress who are present today, and there are a couple in the back room here I think that have come in. Without objection, all Members present will participate fully in the hearing, and all opening statements and questions are made part of the official hearing record.

On September 11th, our world fundamentally changed with the cowardly acts of a handful of terrorists. We all carry with us the memories of the destruction of that day which deprived families of loved ones, people of their jobs, and a Nation of one of its greatest landmarks.

In addition, the losses of September 11th represent the single largest hit to our insurance industry in the history of the United States.

Since then, our insurance markets are facing a new reality. Insurers are being asked to insure terrorism risk when they have no realistic way to determine the fair price for that risk, or in the vast majority of cases, being able to obtain any reinsurance for it.

This risk is one which no one ever anticipated. Moreover, no one can presently calculate the proper odds for where or when the next attack will occur. We do know, however, that our Government officials believe that we should expect additional and costly attacks.

Consequently, the vast majority of insurers have been loathe to cover terrorism, especially for major buildings, factories, or gathering places. Where terrorism insurance is available or is required by law, insurers must charge high premiums for it and offer very limited capacity to protect against the risk of insolvency.

Today, nearly 6 months later, we continue to discover further repercussions from the acts of terror on New York and Washington. One such symptom is the pervasive risk transfer that is currently occurring from reinsurers to insurers of American businesses leaving such businesses vulnerable to future terrorist attacks.

I think the GAO put it best in their report, and I am quoting from that report:

"Since the September 11th attacks, the key dynamic taking place in the insurance industry has been a shifting of the risk for terrorism-related losses from reinsurers to primary insurers and then to the insured. Reinsurers and insurers have begun shedding their exposure to terrorism risk as insurance contracts have come up for renewal, leaving policyholders increasingly exposed to losses from a terrorist attack."

The GAO goes on to say: "Large companies, businesses of any size perceived to be in or near a target location, or those with some concentration of personnel or facilities, are unlikely to be able to obtain a meaningful level of terrorism coverage at an economically viable price."

The focus of the GAO's inquiry was on the availability of property and casualty insurance and reinsurance. That is clearly important. But we also need to consider whether there have been similar detrimental effects with respect to terrorism coverage in the group life insurance area.

I hope we can get some enlightenment on that question, as well.

It is clear that the current lack of terrorism coverage acts as a chill factor restraining our economy, which is struggling to recover from recession. Businesses, particularly in cities and near targets, seeking to build are being required to carry terrorism insurance.

However, I am informed that there is little or no terrorism coverage available and hence some new construction is being stopped before it can even start.

This is causing the loss of new jobs at a time when creating jobs should be one of our highest priorities. In short, the Senate's leadership failure to act on terrorism insurance legislation is imposing a fear tax on America, costing real jobs when the country is trying to pull out of a recession.

In addition, since the Administration says that another terrorist attack is extremely likely, we must plan for how the Government should react to such an attack now, not after another attack.

We have learned countless lessons from September 11 on homeland security and distributions from September 11th charities which could have avoided many problems with a little more planning beforehand.

Acting now will preserve a private market mechanism to provide terrorism coverage, capital, and a claims processing system.

Waiting until Americans suffer the next terrorist attack to respond is irresponsible, inefficient, and will ultimately cost the Government much more than taking responsible action now.

Victims will most likely suffer months of additional delays as Congress scrambles to create a bureaucracy to determine which victims get compensated and in what amounts.

This can be especially harmful to small businesses which cannot afford to wait months after a tragedy while Congress decides whether or not and how to respond.

As a former small business owner, this concerns me greatly. Under the leadership of Chairman Oxley, this subcommittee acted quickly last year to pass legislation, H.R. 3210, the Terrorism Risk Protection Act, to protect the U.S. economy, its businesses, and its workers from the negative effects that are materializing today. It is stuck in the Senate.

I sincerely hope that the Senate leadership will act quickly to avoid a potential calamity. Today we will hear from a list of very distinguished witnesses to gain a better understanding of how the lack of Federal legislation has and will affect commercial consumers, builders, lenders, investors, workers, schools, hospitals, public entities, and private institutions.

I would like to thank all of the witnesses for appearing today, and for those of you who submitted written testimony for the record, and for the witnesses who have extra written testimony I thank you for submitting that for the record.

At this time, my good friend from Chicago is on the floor, so I am going to go back to him for his opening statement. But I am going to right now turn to Mr. Tiberi. Have you an opening statement, Mr. Tiberi?

[The prepared statement of Hon. Sue Kelly can be found on page 44 in the appendix.]

Mr. TIBERI. No.

Chairwoman KELLY. Mrs. Biggert.

Mrs. BIGGERT. Thank you very much, Madam Chairwoman, and I appreciate your courtesy for allowing me to attend this hearing.

Madam Chairwoman, January 1st has come and gone and, as predicted, a major change in insurance and reinsurance coverage is taking place that threatens our economy.

Months ago in the wake of 9/11, many Members here predicted what has now in effect occurred. Most reinsurance renewals now exclude coverage for terrorism, and most primary insurers will exclude terrorism coverage in the coming months.

It is because we anticipated this outcome that we on this subcommittee and the Full House acted quickly late last year to pass a terrorism insurance bill. But sadly, our Senate colleagues did not take quick action. They did not take any action before the January 1st renewal deadlines, and not since January 1st.

Unfortunately, as with so many other issues during this Congress, when it comes to terrorism insurance and reinsurance coverage, our colleagues across the Capitol seem to have their heads buried in the sand.

It is my hope that some of our Senate colleagues might be motivated by the comments made this morning by Federal Reserve Chairman Alan Greenspan, who did not mince his words.

He said, quite simply, that passing a terrorism insurance bill is critical to stabilizing the marketplace. Chairman Greenspan is not alone in this view.

Even the General Accounting Office has noted that without a terrorism insurance bill there will continue to be a significant drag on our economy.

Unfortunately, this burden has fallen particularly hard on one segment of the economy that can least afford to live without terrorism coverage—our public self-insured risk pools.

These risk pools, more than 125 operating in 41 States, help local governments, school districts, housing authorities, and other public entities to provide necessary insurance protection. They provide coverage to those most often at greatest risk—police officers, firefighters and emergency medical personnel, as well as teachers and students, municipal employees, and many others.

We all know that these public entities cannot absorb the costs of terrorism risk across their membership base. I have heard from several risk pools in my State that are desperate for help.

In Illinois, the Assisted Housing Risk Management Association no longer has coverage for an act of terrorism. That self-insured pool covers public housing authorities across my State.

The Illinois School District Agency, a self-insured risk pool covering public school districts in Illinois, has been told that its July 1st renewal will have a terrorism exclusion.

And the Department of Insurance in Illinois is now allowing the exclusion of terrorism coverage in new and renewable policies.

So my State becomes one of the 45 States that are allowing such exclusions to be written in to policies. The need for Congress to act has never been greater. Large self-insured pools and individual self-insurers such as the City of Chicago will pay as much as four times their expiring premium to buy the additional coverage necessary in the coming year.

Make no mistake, public self-insured risk pools are more vulnerable than other entities. They provide enormous savings to taxpayers. In choosing to do nothing, the Senate threatens to undermine a system that our policemen, firemen, school teachers, tradesmen, assembly line workers, commercial property owners, and others depend on.

Without a Federal solution, our workers, businesses, and public institutions will suffer. I hope that the members of this panel will not hesitate to place the blame where it belongs, with the Senate.

I thank you, Madam Chairwoman, and I yield back.

[The prepared statement of Hon. Judy Biggert can be found on page 48 in the appendix.]

Chairwoman KELLY. Thank you, Mrs. Biggert.

We have been joined by Dr. Weldon. Dr. Weldon, do you have an opening statement?

Dr. WELDON. Madam Chairwoman, if I could just for 30 seconds, I want to commend you on this very important hearing and thank all of our witnesses for being here.

I am particularly interested in this issue not only on the merits of the topic being discussed, but as well, the parallels between this issue and natural disaster insurance and the whole reinsurance issue.

I think there is a fair amount of common sense in that. So I am looking forward to hearing the testimony of the witnesses. Thank you.

Chairwoman KELLY. Thank you very much, Dr. Weldon.

Since there are no more opening statements, we will now begin with our witnesses on our first panel.

Before us today we have Mark Warshawsky, the Deputy Assistant Secretary for Economic Policy at the United States Department of the Treasury.

Then we will hear from Richard Hillman, the Director of Financial Markets and Community Investments for the U.S. General Accounting Office.

And finally, we have the Honorable Greg Serio, who is the Superintendent from the great State of New York. He is with the New York State Insurance Department. This is not Mr. Serio's first time before this subcommittee and, Mr. Serio, we welcome you back.

Thank you all for joining us here today to share your thoughts on these issues. Without objection, your written statements will be made part of the record. You will each be recognized for a 5-minute summary of your testimony. There are lights in front of you that will indicate how much time you have. The green light signifies you are in your first 4 minutes. The yellow light will turn on when you have 1 minute left. And the red light will turn on when your time has expired. We hope you will observe the lights.

We will begin with you, Mr. Warshawsky. Thank you.

STATEMENT OF MARK J. WARSHAWSKY, DEPUTY ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. WARSHAWSKY. Thank you. Madam Chairwoman and Members of the subcommittee:

I appreciate the opportunity to present to you the views of the Office of Economic Policy at the Treasury Department on the impacts of the lack of terrorism risk insurance on the American economy.

We appreciate the speedy action of the House in passing legislation last year that would have created a temporary Federal backstop for private insurance.

We look forward to continuing to work with you to restore private insurance coverage for this risk. My testimony is divided into three parts:

The effects of the terrorist attacks on the ability of a business to insure against risk;

The impact on the economy; and

Our need in the face of the continued terror threat to move legislation forward.

The impact of the terror attacks of September 11th and the capacity of insurers and reinsurers has been very large. Insured losses of both primary insurers and of reinsurers over all principal lines of coverage now are estimated to be about $40 billion.

These will be the largest insured losses in history, far surpassing those from Hurricane Andrew in 1992. The capital of the industry was in a sense hit doubly by the attacks. The Stock Market declined sharply following the attacks, reflecting general business uncertainty, and the insurers' investment losses accelerated dramatically as a result, creating the possibility of the failure of insurance companies.

In addition, the attacks revealed to the insurance industry a potential for huge future losses which it had not priced before and cannot yet readily model.

Terrorism risk is not like normal insurance which pools many small risks. It is somewhat more comparable to traumatic natural catastrophes such as hurricanes and earthquakes, but unlike natural catastrophes terrorism risk does not have predictable patterns and probabilities quantifiable by sophisticated models.

As a consequence of their reduced capital base and the inability to model terrorism risk, reinsurers have almost entirely stopped assuming terrorism risk.

Primary insurers which rely on the ability to lay off huge risks to reinsurers are also withdrawing from covering this risk as their contracts expire.

Primary insurers are being allowed by insurance commissioners in all States, with the exceptions of New York, California, and Georgia, to exclude terrorism coverage above certain small dollar amounts from smaller regulated commercial policies in the future.

Insurance brokers report that terrorism coverage for large commercial properties whose insurance policies are unregulated is difficult or impossible to obtain. And, when available, subject to the limits of coverage that are much lower than customers need.

And premiums for these properties have increased dramatically. The total policy costs with limited terrorism coverage is reported to be roughly double the cost of a property casualty policy without the terrorism coverage.

These insurance difficulties in turn are affecting the financing of new real estate projects and the sales of existing properties.

Financing is limited for new construction and the acquisition of high-profile properties. Lenders are carefully screening the location and size of buildings. Some are simply refusing to lend to properties that are not fully insured.

Much commercial property development is financed through the sales of securities backed by mortgages on the properties. The securities depend on good ratings from rating agencies to attract investors.

Rating agencies have indicated that they will substantially downgrade new issues of securities backed by mortgages on high-risk properties without adequate insurance coverage.

Those deemed high-risk include trophy assets, symbols of America, structures for large gatherings of people, critical infrastructure, and critical energy providing structures.

The implications of these insurance market conditions and the economic consequences make it critical for Congress to enact a Federal terrorism risk insurance backstop.

The lack of insurance coverage leading to inefficient risk bearing and high premium rates imply a drag on our economy and a burden to the nacient recovery, including the potential for loss of even more jobs.

These costs are like a tax increase on the productive capital, a disincentive to investment, and in the long run a considerable burden for our workers and consumers.

Our enemies have stated that their intent is to cause both economic and physical harm to us. And as the President has warned, our enemies are persistent, clever, and should not be underestimated.

We firmly believe that our Nation's battle against the scourge of terrorism will ultimately be successful, and that private insurance markets will stabilize in the long run.

But we now know how difficult and costly it can be for the economy to adjust to terrorist events. We want to encourage economic growth, and we bear a responsibility for assuring that our citizens are adequately protected against terrorism.

Consequently, we urge that Congress pass a Federal backstop now before the damage caused by lack of terrorism risk insurance takes too great a toll on our recovering economy.

We know that you share with us a clear recognition of the importance of this legislation, and we want to work with you to create the best possible support for our economy and our citizens.

I will be glad to answer any questions.

[The prepared statement of Mark J. Warshawsky can be found on page 51 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Warshawsky.

Now we go to Mr. Hillman.

STATEMENT OF RICHARD J. HILLMAN, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENTS, U.S. GENERAL ACCOUNTING OFFICE

Mr. HILLMAN. Thank you, Madam Chairwoman, and Members of the subcommittee:

I am pleased to be here today to present the results of our work on the availability of terrorism insurance in the wake of the tragic events of September 11th.

As you requested, my testimony today describes how in the absence of Federal action insurance companies and the marketplace have reacted to the events of September 11th.

My testimony also provides GAO's initial observations on the potential consequences these market changes may have both in the event of another terrorist attack and, as we all hope, in the absence of one.

On my first point, since the September 11th attacks, the key dynamic taking place in the insurance industry has been a shifting of risk from terrorism-related losses from reinsurers to primary insurers and then to the insured.

The tragic events of September 11th brought to light the huge potential insurance company exposures that they could face in the event of another terrorist attack.

Faced with a continuing uncertainty about the frequency and magnitude of future attacks, and at the same time warnings by Government and military leaders of new attacks to come, both insurers and reinsurers have largely determined that terrorism is not an insurable risk at this time.

As a result, in the closing months of last year reinsurers, followed by direct insurers, began announcing that they could not afford to continue providing coverage for potential terrorism losses.

Because reinsurance markets are global in scope, and because reinsurance transactions are considered to be contracts between sophisticated parties, neither the prices nor the conditions of such coverage are subject to direct regulation.

As a result, after September 11th, reinsurers had little difficulty excluding terrorism from coverage. Generally these exclusions became effective on policy renewal dates, many of which were clustered at the beginning of January.

Industry sources confirm that little reinsurance is being written today that includes coverage for terrorism. As reinsurers walk away from terrorism insurance, primary insurers' exposures increase, at least in the short run.

Faced with this kind of exposure and the risks that they do not believe can be priced, industry observers and participants have told us that the primary insurers are beginning to emulate their reinsurance counterparts and exclude terrorism coverage from some commercial insurance policies.

However, a number of factors affect both the speed and the extent to which primary insurers can insulate themselves from terrorism losses. Direct commercial property casualty insurers withdrawal has been slower and less complete than reinsurers because, with the exception of some large risks, direct insurers need regulatory approval to exclude terrorism.

Moreover, there are legal requirements in some States that preclude insurers from excluding terrorism from coverage for Workers Compensation and for fire following an event, irrespective of its cause.

However, the rapid submission of the ISO exclusion language in which the State insurance regulators and the generally rapid positive response by regulators clearly indicate the urgency of primary insurers' desire to be able to exclude terrorism from commercial property casualty insurance coverage.

Over the next year, as insurance policies renew, a growing share will likely exclude coverage for terrorism, absent some intervening factor. Thus, risks that were formerly held by reinsurers and insurers will gradually be shifted back to the policyholders.

Now all policyholders are affected by this shift to the same extent. Indeed, small, low-risk businesses and properties may feel little effect. However, large risks and those where there are factors that give rise to a perception of risk such as location, concentration, or hazardous activity, are experiencing problems obtaining insurance for terrorist events and policyholders are thus bearing more of the risks of loss themselves.

Regarding my second point, the effects of the risk shift from reinsurers and insurers to businesses and property owners can be invited into two parts:

What would happen in the event of another terrorist attack?

And what is happening even in the absence of another attack?

Many of the most severe potential negative consequences resulting from a lack of terrorism insurance coverage will only become evident if another terrorist attack occurs.

The shifting of risk from reinsurers to primary insurers to commercial property holders and other affected parties could place more risks and economic burden on businesses and the public at large should another terrorist attack similar to a September 11th occur.

Consequently, a lack of such coverage in the event of another attack could have more serious effects on businesses as well as their employers, lenders, suppliers, and customers.

Another significant consequence of the insurers exiting the market for terrorism coverage is the loss of their claims handling mechanisms for effectively and efficiently responding to victims of an attack.

However, even in the absence of an actual terrorist event, there are growing indications that some sectors of the economy—notably real estate and commercial lending—are beginning to experience difficulties because some properties and businesses are unable to find sufficient terrorism coverage at any price.

Such large property owners or developers reported that they are having to underinsure or go bare by self-insuring for terrorist risk because of the lack of available coverage or very limited coverage for the quoted prices.

Developers, financial institutions, and the insurance industry observers have told us of cases where lenders or investors were reluctant to commit resources to projects that could not be insured against terrorist attacks because they were unwilling to expose themselves to risks that insurers could not price.

In my written statement are examples of these effects and recent news articles have identified still others.

In summary, our Government leaders continue to warn of imminent and credible terrorist threats. Should one of these threats become a reality in a world where insurers ar no longer the first line of protection for businesses, the economic consequences could be very different from those following September 11th.

As businesses both large and small are faced with uninsured losses that threaten their ability to survive, Congress could be faced with a time-critical decision to intervene or not. Deciding whether Congress should act to help businesses obtain insurance against losses caused by terrorism is properly a matter of public policy. The consequences of continued inaction, however, may be real and are potentially large.

Madam Chairwoman, this concludes my prepared statement and I would be happy to respond to any questions.

[The prepared statement of Richard J. Hillman can be found on page 57 in the appendix.]

Chairwoman KELLY. Thank you, very much. As perhaps you see the lights up there, we have been called back not for one vote but, as I understand it, for perhaps a series of votes. Unfortunately, I had intended to start the hearing and let it go right straight through, but if we have a series of votes I am going to be unable to do that because we all have to be on the floor to vote.

So I am going to temporarily recess the hearing for a brief period until the voting is finished on the floor. I am sorry. Procedurally, what is happening on the floor right now is very interesting to people who are students of the Congress, but it is taking your time and I apologize to people who have planes to catch and so forth. We had hoped to get this done in a timely manner. Apparently we are not going to be able to.

So I am temporarily going to recess this hearing. We will come back when the votes have finished. Thank you very much for your patience.

[Recess.]

Chairwoman KELLY. This hearing will now resume. Thank you very much for your patience. I apologize for the time.

Let's go now to Mr. Serio.

STATEMENT OF HON. GREGORY V. SERIO, SUPERINTENDENT, NEW YORK STATE INSURANCE DEPARTMENT.

Mr. SERIO. Thank you, Madam Chairwoman. It is a pleasure to be here, and I appreciate the opportunity to give you a sense of what we have seen in the New York market.

As you might say, you can't get any closer than we have been to the situation, and that continues even as the recovery efforts continue at Ground Zero.

I am going to deviate from my prepared oral comments and just give a sense of what we have found. It is very similar to what has been testified to already.

The availability issue is one that we have seen coming for some time. Back in December of 2001, the Insurance Department surveyed the commercial property and casualty business companies writing in New York, and this is what we found:

As far back as December, we knew that 54 percent of the companies writing business in New York planned to reduce coverage limits on both new and renewal business.

We knew that 12 percent planned to materially curtail the number of policies written in certain lines of business. Eleven percent had ceased writing or materially reduced the number of policies written in New York. And 18 percent did so outside of New York as well. So it is not just related to New York.

Twelve percent planned to cease writing or materially reduce the number of policies in New York for 2002, and 24 percent of the companies responding said they planned to reduce their writings outside of New York in 2002 as well.

Eighty-one percent of the insurers responding to our survey are licensed in our Free Trade Zone, which is an area where you can write sophisticated risks free of rate and form regulation, but that they were going to exclude or limit coverage for acts of terrorism. And that 83 percent indicated that their reinsurers excluded or limited coverage for acts of terrorism.

So we knew that. And living in New York, and having our offices just blocks from Ground Zero, we also found by local meetings and public forums that the New York Insurance Department has been undertaking over the last several weeks and will continue to do so, we have found that a lot of what was answered in our surveys in December are coming true now in the market.

Our public forums have had one business after the other coming before us, talking about difficulties in gaining coverages, particularly going bare or particular difficulties getting terrorism coverage.

We have met with local business groups. Some of the groups are here today, and you will hear them in the second panel. In speaking with business owners, one on one, and in walking tours that I have done not just in Lower Manhattan but also in Albany, on Long Island, and throughout Upstate New York, we are finding that this is not a New York-centric problem; that it is very much indeed a problem throughout all of New York and, by our numbers, clearly one that is starting to affect other States as well.

The second question that you had in the letter to us inviting us to testify:

What is the impact on the economy?

Well, I can tell you that it hasn't been geographic in nature. It is not sector-oriented. And let me just add one more observation. It is not just limited to businesses. Governments themselves have had tremendous difficulty getting insurance coverages, particularly terrorism coverages, and largely because they are what might be considered to be terrorist risks or targets, but also because, as natural places of assembly for large numbers of people, carriers are reluctant to write Government risks, including public buildings of assembly, bridges, and other types of publicly operated or Government-operated facilities.

The economic viability of the insurance industry to absorb losses, which was the third question in the letter to us, really cuts to the heart of the matter.

That is, that if it is a man-made threat, as the Chair has noted, that the threat of future and different terrorist acts are still with us.

I have as much of a concern over what happens in the court of natural disasters that might come up, and the ability of the industry to weather those storms.

Hurricane season is just 3 months away and is before, by the way, the next largest reinsurance renewal period, and I can tell you that every Gulf State and every State on the East Coast of the United States needs to be concerned about the event of a natural disaster having that second shoe dropping effect on the insurance community in the United States. And that is something that certainly begs the question of some action here in Congress.

Another point I would like to make is that we have been looking at insurance companies not just as insurers and having the capacity to cover risks, but also as participants in the marketplace as businesses, and more importantly as investors in the real estate market in New York and in other large cities.

I can tell you that there is an insurance company that is, or has been known to be the single, or second-largest real property owner in the City of New York. What are the implications, when you consider that those investments that they have serve as the admitted assets of those companies if those assets are now suddenly challenged because they don't have all-risk coverage or go bare for terrorism coverage?

So we have to take a look at that issue, as well.

The Department's response has been, since 9/11, first to deal with the claims' issues at hand; but, second, to get to the question of how do we maintain coverage going forward.

The most profound action that we have taken and one that certainly raised the hackles of certainly the trade press in the insurance community, was to deny—and I think I used the term—I wasn't inclined to approve terrorism exclusions.

That is because, as I looked outside my window in Lower Manhattan, and also from our perspective around the rest of the State, terrorism coverage, or terrorism exclusions, I should say, that are overly broad simply are in violation of the State law.

They may work for other constituencies in other jurisdictions, and maybe that is one of the beauties of the State-based system of insurance regulation, but for New York terrorism exclusions were not appropriate.

We have pushed back to the companies to give us more definitive exclusions, more narrower language with respect to those exclusions, but I can tell you that at the end of the day we do not want to make businesses and consumers the last stop on the "Pass-The-Exposure Express."

And for all of these reasons, we believe that time is now passing for Congress to take action, and we believe that this is nothing new. We are not talking about new ground. But that it is something that, with the examples we have used in the past, either permanent facilities or temporary facilities that we have used in New York in the past, I think we can settle the challenge that is in front of us.

Thank you.

[The prepared statement of Gregory V. Serio can be found on page 77 in the appendix.]

Chairwoman KELLY. We thank you, Mr. Serio.

I am going to ask a couple of questions of you, Mr. Warshawsky. In your written testimony you compare the current economic impact of a lack of adequate terrorism coverage to a tax on productive capital.

I wanted to know if you would elaborate that for us a little bit.

Mr. WARSHAWSKY. Sure. Basically it comes in two mechanisms. The lack of adequate, or any insurance increases the risk exposure of businesses. And as the risks increase, risk has a cost. And the cost is either reflected in increased cost in borrowing, or a decline in equity values, and therefore that sums to an increased cost of capital like a tax on capital.

The other extent to which there is the tax of course is the increase in the premium on any insurance which is purchased. So those two summed together would be considered what I would call quote, unquote, a "tax" on productive capital.

Chairwoman KELLY. Thank you. Another question for you.

In your written testimony, you note that those who argue that the lack of a current dramatic impact proves legislation is unnecessary, that they misunderstand the problem.

The witnesses that we have heard today of the three of you seem to agree with that. I would like you to just elaborate a bit on that, too, please.

Mr. WARSHAWSKY. Sure. Basically there are sort of two prongs to that, as well. The most significant one is going forward. That is, that many properties, many businesses and governments as we've just heard are exposed. They are either inadequately insured or not insured at all.

And if there were to be another terrorist attack, then there would be a need to hurry up and devise some other method.

So, you know, that does not speak to the current impact; it speaks to the future impact, which I think is what I was referring to as a misunderstanding of the fundamental problem.

That being said, I think we have found an impact already, an economic impact, as we have discussed both in terms of real estate development and other sectors of the economy, and so I think the impact is there as well.

Chairwoman KELLY. Thank you.

Mr. Serio, you categorized the market effect of a lack of available terrorism insurance as a slow death by a thousand cuts. Interesting simile. Rather than a second capitation. And yet, you feel that the Federal Government should act now?

Mr. SERIO. My creativity aside——

[Laughter.]

Mr. SERIO. I have to tell you, what we are really finding in the marketplace—and this has been part of the concern that we have had about the pass-through down to businesses and consumers—as much as it has been a challenge to the primary carriers to have them retain the risk for terrorism losses and exposures, it has given us an opportunity to really get our hands around not just the core of the issue, but also how comprehensive the issue is to the overall primary insurance market.

When it comes down and you have the pass-through to individual businesses, it is diluted by each business, as well as by each expiration of coverage and each renewal period, or each renewal cycle for each type of business.

Something we have seen in our Department has been that we have been getting calls, one business, one sector at a time, and it has been difficult to really articulate or to illustrate the burgeoning problem when we have had to do it one sector, one business at a time.

So the primary carriers may feel that they are taking the heat on this, but I think it has really allowed us to illustrate quite clearly what the implications have been arising from the lack of reinsurance for terrorism.

Chairwoman KELLY. The other thing I noticed, you picked a number of different areas, but one that particularly stood out with me was you noted that hospitals are having difficulty in getting adequate terrorism coverage for their facilities.

What happens to these hospitals and their employees if they can't get coverage? And what happens if there is another terrorist attack? We in New York know how very vulnerable we are to something like that, and how might this end up affecting other health care costs in New York?

Mr. SERIO. Actually the hospitals, and I have to appreciate them coming forward, and I know they are here today, they really were the first illustration of a major sector of dysfunction with respect to getting coverage.

They had a renewal cycle back in November, and it has only been recently that we have been starting to look at what is the exponential impact, as you've suggested in the question, and what happens if you have a health care facility that is only covered for a portion of their true liabilities? And given the health care industry in New York where there is a large public/private interplay in the financing of hospitals and health care facilities, you are talking about a broader exposure not just in terms of general health care costs but also in terms of public health care financing as well.

I think the hospital representative can probably better demonstrate that, but that is part of that exponential concern that we have that it will go far beyond just the bricks and mortar of those hospitals to getting into actual health care financing dilemmas and challenges for us if a hospital that is underinsured were to have a loss.

Chairwoman KELLY. Thank you, very much.

My time is up. I am turning now to the Ranking Member, my friend Mr. Gutierrez.

Mr. Gutierrez.

Mr. GUTIERREZ. Chairwoman Kelly, Members of the subcommittee, and distinguished guests, I am pleased that we are holding this important hearing today to discuss an issue that is very present in people's minds since September 11th.

I am sure that all of us in this room let out a collective sigh of relief and joy when the Winter Olympic Games concluded without incident. As our Nation continues to recover from the events of September 11th, I remain confident that the insurance market will also recover.

Nevertheless, and not surprisingly, we all have different views as to how long this recovery is expected to take and how exactly it will happen.

Only last October we heard testimony about the fact that there was great uncertainty as to what would happen if Congress did not act to provide backup for terrorist insurance.

At the time, there was widespread belief that either the industry would experience a devastating setback, or that the potential consequences would at least be severe enough that Congress should worry.

Well, Congress does worry. However, I also understand that the terrorist attacks may have just only begun to effect the market mechanisms to provide terrorism insurance.

While it is reassuring to know that the worst-case scenario did not play out, many answers are still missing. For instance, how much longer before the market corrects itself and the current cycle changes?

What is the cost for this potentially long process?

Has the fact that Congress has not yet provided backup legislation been as detrimental as it was feared in the Fall of 2001?

These are all valid questions that warrant honest answers. Your acceptance to appear before this panel today brings us a step closer in obtaining these answers and expediting a solution to the current problems.

I want to thank our guests for joining us today and I, as always, look forward to all of their testimony.

I would ask the Chairwoman Kelly to provide me an opportunity to put in writing questions to the members that are here before us, and to please excuse me for the remainder of this hearing.

Chairwoman KELLY. Thank you, Mr. Gutierrez, for being here. We understand you have other things that you need, that you must do. And of course, by unanimous consent, we accept your statement for the record.

Dr. Weldon.

Dr. WELDON. Thank you, Madam Chairwoman.

Let me begin with—it's Warshawsky? Is that correct?

Mr. WARSHAWSKY. Yes.

Dr. WELDON. In your testimony you mentioned the similarity between the losses incurred by acts of terrorism and catastrophic risk like earthquakes and hurricanes. You also mentioned that natural catastrophes have predictable patterns that allow for the assumption and diversification of risk, distinguishing them from terrorism.

However, in my State of Florida and in California, and other States that have had catastrophic risk exposure in recent years, the residential property insurance market seems similar to the recent trends in the terrorism insurance market where high premiums and relatively low coverage is being offered for catastrophic risks.

Could you comment on this, particularly with respect to the premium prices and the capacity of insurers to cover losses?

Mr. WARSHAWSKY. Sure. Basically, as I said, there are similarities and there are also differences between the two types of risk. The similarity obviously is in the, at times, very large losses that could be experienced.

The dissimilarities are twofold. One is that typically we have only experienced the terrorism, major terrorism risk once, but what we saw was there was a major—at the same time, of the insured losses, there was a major decline in investment prices.

That introduced more of a risk to the insurer in terms of, because both risks could happen at the same time. That is less likely to happen because of the more and isolated nature of the natural disasters.

The second difference is, it was my understanding that insurers and reinsurers have devoted a lot of effort and intelligence to trying to find patterns in natural disasters, and I believe that that enables them to more accurately price the risk.

That has been used, I'm told, for example in the issuance of catastrophe bonds that have been used both in California and in Florida. But that has not yet come online. I am not sure if it is able to, but it certainly has not yet come online in this risk.

Dr. WELDON. Do you see a parallel between some of the withdrawal of coverage? There has been withdrawal of coverage in the case of terrorism risk, and there has been some withdrawal of coverage in the case of catastrophic risk. I know in the State of Florida, prior to Andrew, we had 1200 companies offering product. We now have, I believe, less than 200 offering homeowners insurance policies.

Mr. WARSHAWSKY. Well, the comparison there certainly motivated our analysis in terms of viewing this as the likely trajectory of losses in the experience in the insurance market.

So following Hurricane Andrew, the dislocation was 18 months to 3 years, and I think here too that is something you cannot project exactly what would happen, but something like that would be expected here as well.

That is why Treasury proposed, the Administration proposed a temporary insurance backup.

Dr. WELDON. Mr. Hillman, you state that another terrorist attack will place the economic loss on policyholders because insurers have withdrawn or limited their risk to such exposures.

Would you agree that this is the same dynamic that is occurring regarding catastrophic risks from hurricanes and earthquakes?

Mr. HILLMAN. Certainly with terrorism insurance this risk-shifting process that is taking place is much more dramatic than what has been experienced in the past associated with natural disasters for very similar reasons that my friend from Treasury has stated:

That there are opportunities to develop sophisticated modeling methods with which to determine with some predictability the prices for natural catastrophe insurance. That today does not exist for terrorism insurance, and therefore you are finding reinsurers and primary insurers in the industry fleeing from the marketplace.

Dr. WELDON. Mr. Serio, I believe you may have commented on this in your opening statement. I got here a little late, but in addition to the exposure to terrorism, New York obviously also experienced some exposure due to catastrophes such as hurricanes. I grew up in New York and I remember some of the hurricanes that came through there.

New York has consolidated its response to these risks in its Emergency Management Office. What have been the impacts of the September 11th attacks on New York's ability to respond or prepare for other disasters such as a natural disaster?

Mr. SERIO. I think—and getting the Insurance Department more directly involved with the Emergency Management infrastructure I think has given us a new perspective on that very question—I think the direct answer to your question is in how the Emergency Management infrastructure responded to the crash of Flight 587 in the Rockaways just 2 months after the World Trade Center disaster.

I can say that both the State Emergency Management apparatus and the City Emergency Management apparatus, which you may know was destroyed entirely in Building 7 of World Trade, is now up and running in temporary quarters in Brooklyn, but never had there been a default in the interface between the City and State Emergency Managers, and I think that is in large part the reason why the response to World Trade and American Airlines was so good.

And so as we approach hurricane season, I think that the State of New York and its localities are in a good position to respond to a natural disaster.

The industry I think is also in a good position to respond to a natural disaster because of what they learned from World Trade.

I think their concern is certainly more financial than procedural in terms of their ability to get in and to handle a large risk, something in the order of whether it's an Andrew at $19 billion or something like World Trade which is substantially more.

Dr. WELDON. I was very interested in your comments about the nature of the real estate investments for some of the insurance companies.

Do you feel that the reinsurance market as it currently exists today is adequately serving the insurance needs of the major insurers in the City and State of New York?

Mr. SERIO. Up to this point in time, we have not been receiving complaints from the primary insurance market as to the inability or the failure of their reinsurers to pay.

Out of the $15 billion that has either been claimed or paid up to this point, that still has largely come out of the primary carriers, although the reinsurers as their layers start to—the attachment points start to be met, they have been paying them and we have not had any unusual deviations from the normal practice of timely payment of reinsurance recoverables.

So they seem to be doing as well a job in paying their primary carriers as the primary carriers are in paying their insureds and their commercial insureds.

Dr. WELDON. Do either of the other two witnesses want to comment on the status of the reinsurance industry and the impact of this disaster on that? Did you have anything to add to what Mr. Serio said?

Mr. WARSHAWSKY. Nothing to add.

Mr. HILLMAN. Nothing.

Dr. WELDON. Thank you very much, Madam Chairwoman, for this very interesting hearing that we have had.

Chairwoman KELLY. Thank you, Dr. Weldon.

I would like to ask a couple of other questions here. I would like to go on with what Mr. Serio was saying.

Mr. Serio, on page 13 you testified about the dangerous risk shifting to policyholders and the resulting economic drag.

What about the effects on group life and workers compensation markets that are so important for protecting our citizens? And how are those markets now being affected by this situation?

Mr. SERIO. The over-concentration-of-risk issue has really come home to roost in the group life and in the workers compensation area.

We have a situation not just in New York but frankly countrywide where reinsurance for workers compensation has, I think one commentary said, it has evaporated.

There is significant concern for catastrophic reinsurance for workers compensation. Already in New York and in other States the rating services, the New York State Compensation Insurance Rating Board has already approached the Department for an emergency rate increase to cover the catastrophic reinsurance expense that they are incurring right now. We are in discussions with them on that question.

But if it is reinsurance which is not usually part of the rate base for workers compensation, what we may end up with is either a workers compensation environment where if they cannot get adequate recoveries for their rates, they will significantly curtail the writing of workers compensation business.

In turn, the residual markets will once again become primary carriers and the primary writers in those markets, and I do not think that is good for business. And frankly, it is not good for the State that sponsors the residual market.

Chairwoman KELLY. Thank you, very much. It does not paint a very rosy picture.

Mr. Hillman, the GAO report concludes that the potential negative consequences of not having terrorism insurance are cause for concern.

It seems to me like it may be a very nice way of saying we should be concerned. If you say that the consequences of continued inaction may be real and are potentially large, what are the benefits right now of putting in a contingent Federal backstop in place versus the cost of just waiting around until another terrorist attack happens and considering how to respond at that point?

Mr. HILLMAN. The decision rests with the Congress as to whether or not they ought to implement a plan, but there are at least several reasons that I could think of as to why it would be better to act now.

Number one, simply it would be a prudent act to develop a plan when you have the time to develop a plan right. Under a crisis in the event of another attack would not be the right time to be thinking about how to deal with the terrible situation.

Second, you want to keep insurers capital and their claims processing capacity in the game. What we have found from the results of our study is that the claims processing capability of the insurance industry will be quickly evaporating as they insulate themselves from this market.

In the event of another attack, then, it may require the Federal Government to institute new claims' processing capabilities, which is a daunting task.

Finally, acting now would strengthen confidence in all the markets, its participants, lenders, businesses, and insurers, and that could only be good for the economy.

Chairwoman KELLY. Mr. Hillman, do you think that the need—and this is not a trick question—do you think the need for legislation at this point is more about insuring the solvency of the insurance industry? Or more about preventing a risk transfer to the vulnerable policyholders, stopping economic drag, and creating an efficient response mechanism to future terrorist attacks?

Mr. HILLMAN. With this risk shifting that we have been talking about, more risks are first going to be placed off of reinsurers and onto insurers.

In the event of another attack, that could mean then that these primary insurers could have more solvency issues than we have seen in the past.

If an attack would occur later, the insurers themselves would become insulated. And then the problem is going to rest with businesses, and it is going to rest with their employees, their lenders, their suppliers, creating much more economic concern than the major concerns of a September 11th.

Chairwoman KELLY. It sounds as though you are describing, all of you are describing a ripple effect that is gaining with each wave out. Am I correct in that assumption?

Mr. HILLMAN. [Nods in the affirmative.]

Mr. WARSHAWSKY. [Nods in the affirmative.]

Mr. SERIO. [Nods in the affirmative.]

Chairwoman KELLY. You can do something besides nod so we can get this on the record.

Mr. HILLMAN. Yes.

Mr. SERIO. Yes.

[Laughter.]

Mr. WARSHAWSKY. Well, let me do more than nod. Basically sort of the ripple comes in at least two ways. One is, as the insurance contracts expire the lack of terrorism risk insurance becomes more and more widespread.

The second ripple effect is through the investment process. What we have noticed is progressively the rating agencies for, we've focused on commercial-backed, commercial mortgage-backed securities, there is a progressive realization and work in that area, and that is another ripple effect.

I think that can be repeated in other sectors of the economy in other aspects.

Chairwoman KELLY. Thank you, very much.

Mr. Serio.

Mr. SERIO. Yes. If I could just add to that, and this is something that I don't think people are seeing just yet, is the wave or the ripple that comes up. People are concerned about the size of the wave, but I think as Dr. Weldon being from both New York and Florida knows, it is the undertow that is actually more dangerous.

What we are concerned with is not so much the wave as it goes down toward the businesses and the consumers, but what is that backlash, or what is that undertow back from the consumers and the businesses?

That is really where you are going to see the real economic impact if we do not deal with the ripple or the wave as it comes up in the first instance.

Chairwoman KELLY. I want to thank you all. There are no more questions, I don't believe—Dr. Weldon?

Dr. WELDON. No.

Chairwoman KELLY. I want to note that there are some Members who may have additional questions. They may wish to submit these questions in writing. So without objection, the hearing record will remain open for 30 days for Members to submit written questions to the witnesses and to place their responses in the record.

The first panel is excused with our grateful thanks for your spending so much time. We are greatly appreciative. If the second panel will take their seats at the witness table, I will begin the introductions.

While the second panel is taking their seats, I would like to note that I have written testimony that has been submitted by Edward C. Sullivan, the President of the Building and Construction Trades Department of the AFL-CIO. He says in that testimony that:

"Every day that goes by between now and the time Congress completes action on terrorism insurance legislation presents an increasing threat to our members whose livelihood is dependent upon a robust and healthy atmosphere for building and construction. Every day that goes by without a Federal terrorism insurance law on the books presents a serious and escalating threat to the building and construction industry as a whole, and likely to downstream industries like suppliers. This translates into a threat to our economy and a loss of jobs for our members. A Federal backstop for terrorism insurance can do away with both of these threats, and it is as simple as that."

We will insert, with unanimous consent, the entire statement of Edward C. Sullivan into the record.

[The prepared statement of Edward C. Sullivan can be found on page 203 in the appendix.]

Chairwoman KELLY. And now I would like to introduce the second panel. For our second panel, we will begin with David Mair—am I pronouncing that correctly?

Mr. MAIR. Yes, ma'am.

Chairwoman KELLY. Thank you. David Mair, President of the Risk Insurance Management Society, and Director for Risk Management for the U.S. Olympic Committee.

Next we will listen to Deborah Beck, the Executive Vice President of the Real Estate Board of New York.

Then we will hear from Lisa Kramer, who is the President and CEO of the Federation of Jewish Philanthropies Service Corporation.

Next we will hear from Kieran Quinn, the President and CEO of the Column Financial, Incorporated, a subsidiary of Credit Suisse First Boston.

After Mr. Quinn we will hear from Robert Hunter, the Director of Insurance for the Consumer Federation of America. Mr. Hunter has been before the subcommittee before and we welcome you back, Mr. Hunter.

Finally, we will hear from Alice Schroeder, Senior U.S. Nonlife Equity Insurance Analyst for Morgan Stanley.

I want to thank you all for taking so much time out of your busy schedules to join us here today, and I really appreciate your being here and staying with us for this long period of time that unfortunately this has been that we have had with the floor delay.

So without objection, your written statements will be made part of the record. You will each be recognized in turn for a 5-minute summary of your testimony, and we will begin with you, Mr. Mair.

STATEMENT OF DAVID I. MAIR, PRESIDENT, RISK AND INSURANCE MANAGEMENT SOCIETY, ASSOCIATE DIRECTOR FOR RISK MANAGEMENT, U.S. OLYMPIC COMMITTEE

Mr. MAIR. Thank you, Madam Chairwoman.

As you indicated, my name is David Mair. I am the Director of Risk Management for the United States Olympic Committee, and the President of the Risk and Insurance Management Society.

RIMS is the largest professional organization for risk managers worldwide. Some will come to you, Madam Chairwoman, and suggest to you that they represent the consumers of commercial property and casualty insurance.

I am here today because we are the consumers and appreciate the opportunity to share directly with you our story of what has happened in the months since September 11th.

Insurance is a key part of the infrastructure, the financial infrastructure for business in the United States. It provides the capability to address the costs of unforeseen and unpredictable and preventable events, and it provides coverage for companies both large and small.

There are many in the fall who looked and said: “This is an insurance industry issue.” I want to submit to you today that it was not then nor is it now. This is an issue for policyholders.

The buck has now stopped with those consumers of insurance in cities and towns across America. Companies both large and small now assume nearly all of the risk of owning commercial properties and of operating businesses in the United States. These companies are now working and living in a Nation that has been targeted for terror by a most unpredictable type of an enemy.

Some have said to you that this is a very complex situation, and it is, but it is also yet one that I think can be summarized with a fairly simple analogy.

We have been placed on the interstate highway system in our automobiles at highway speed with the protective steel sidebeams having been taken out of our cars and our seat belts taken away.

If nothing happens to us in the United States, we are all going to be fine in this situation. However, if that truck, known as terrorism today, broadsides us in an intersection, the results are going to be devastating.

That is the situation that we are in today in the absence of insurance for terrorism.

In November of 2000, the press was coming to us with the Olympic Games coming up and asking, “How is this going to impact you?” I had the luxury, in mid-November, of being able to say to members of the press the United States Olympic Committee is going to be fine. We have policies that expire after the Olympic Games, which have now just concluded. However, at the end of November that situation changed dramatically when one of our carrier’s rating was downgraded, forcing us back into the insurance marketplace trying to find general liability coverage for the Olympic team going to the games in Salt Lake City.

The insurance marketplace, at a time it was already concerned about terrorism coverage, looked at the headlines which said “Olympics” and “Security” in the same banner headlines day after day after day, and they were rightly concerned.

We went 70 days without being able to find coverage, and finally were able to place it on February the 9th, the day of opening ceremonies for the Olympic games.

We were, however, able to place that at 45 percent of our expired limit. We couldn’t get any more. We placed it at a 250 percent rate increase without terrorism coverage.

Later that same day, we were able to find stand-alone coverage by going to the same carrier that had been downgraded, which no longer met our requirements, and basically calling in a favor. Because we already had a 3-year guaranteed rate program that simply we couldn’t utilize because of the downgrade, nor could we get excess coverage written over the top of that.

We were able to place that terrorism coverage at 5 percent of our expired limit for 100 percent of the expiring premium.

Some will tell you, Madam Chairwoman, Mr. Weldon, that there is coverage available in the marketplace today, and that it may be affordable. Well, in our membership we have 900 companies that represent small businesses, companies with less than 500 employees. They can't take that same rate increase that we incurred only because we were concerned about America's athletes and the interests of America's Olympic teams at the games.

In small businesses, as you know, that comes right off the owner's dining room table. It comes right out of the pockets of their family, their disposable income, and what they can afford to pay their work force.

Is there a drag? Yes. Is it happening slowly? Absolutely. This is a crisis that is happening in slow motion.

My father is a small businessman in Oklahoma. His insurance coverages does not renew until July. He has not seen the impact of this yet. But he will.

Large businesses have been looked at with the comment that there are all kinds of alternative risk financing vehicles that they can utilize, and that is generally true. But those same large vehicles go to the reinsurance community and are buying insurance which is today not available.

It simply cannot be found at any price.

The Congress has had its own experience. When Anthrax was found in the Senate office buildings, that building was closed for a matter of months at a cost of millions of dollars, with the Federal Treasury serving as the backstop.

Imagine what would have happened had that been a mid-sized business somewhere. Without the availability of terrorism insurance, they would have been unable to afford that cost, and they simply would of had to close their doors and go away with a loss of jobs there.

There are some who will tell you that, in an attempt to deflect the focus, this is a simple issue. It's an issue of increased prices. It's an issue of whether or not claims costs from September 11th will be paid.

It is simply not that easy, nor that simple, at one level. More important is whether the terrorism coverage that will exist will be there to respond, and today it simply is not.

I am a risk manager. My job is to identify the causes for loss and prevent them to the greatest degree that I and my colleagues can, in our businesses.

The environment we are in today is similar to looking at a national forest and saying: "I don't see smoke, therefore there's no fire." We should more appropriately be looking to see whether there are unattended campfires ready to catch and set fire to the woods around us. Unfortunately, it is the terrorists lurking in the shadows who hold the matches.

Again, we are in a car on the highway. The steel beams have been taken away from us. We are simply waiting to see, by action of the Congress, by action of the Senate, whether those steel beams will be put back in the car before something happens.

I thank you for the time, and I will appreciate the opportunity to answer questions as you ask them.

[The complete statement of David I. Mair can be found on page XX in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Mair.

Ms. Beck.

STATEMENT OF DEBORAH B. BECK, EXECUTIVE VICE PRESIDENT, REAL ESTATE BOARD OF NEW YORK

Ms. BECK. Chairwoman Kelly, thank you for the opportunity to appear on behalf of the real estate industry.

My association represents over 5,000 owners, builders, institutional owners, and investors, as well as others involved in New York City real estate.

Our members also have interests across the Nation and globally. You may have seen the *New York Times* piece today, which unfortunately missed the point where terrorism insurance for large commercial properties is concerned.

I am here to confirm that every day without legislative action is putting America's economy further at risk. Lenders demand terrorism coverage for making or renewing large-scale loans. Limited availability is stopping them from doing so.

Investment in real estate is faltering as the risk of loss from terrorism is being transferred from insurers to commercial property owners.

As of January 1st, 70 percent of reinsurance for terrorism ceased. By July 1st, there will be none. Without reinsurance, the primary carriers will not cover terrorism risks for large urban or suburban, or for other properties near what are considered to be terrorism targets.

While lenders insist on full terrorism coverage, only four companies are offering it, limited in the aggregate to $10 billion.

In New York City alone, high-rise office and residential buildings have a replacement cost of $300 billion, not including our valuable religious institutions, universities, hospitals, and the like.

Here are some specifics of pending defaults, stymied sales, stymied refinancings, and deferred construction projects, a direct result of the lack of terrorism coverage. There are more details in my written submission.

A real estate portfolio with property in cities like Chicago, Boston, and New York, and elsewhere, carried blanket coverage of a billion dollars before September 11. Since then, for this owner and in general blanket coverage is no longer available on renewal. Now, the owners are technically in default on their loan.

Owners of a $3 billion mixed portfolio in the Mid-Atlantic and New England States operate by building and then borrowing against completed projects to finance future ones. They cannot get adequate permanent financing on a recently completed fully occupied building because terrorism insurance is not available. The company has 2,000 employees, some of whose jobs are now at risk.

A bank agreed to refinance a $200 million mortgage, but in January suddenly withdrew from the transaction over the terrorism insurance issue just before closing. In this and in another similar case, lenders are stalling by discussing everything but terrorism insurance.

Mortgage brokers we have spoken to assume the lenders want to be ready to lend and hope that Government will resolve the terrorism insurance issue before they must decide whether to commit. An East Coast and Chicago hotel builder with projects averaging $300 million cannot finance without terrorism coverage and so will not start any new construction. Hotel industry unemployment will increase.

Inadequate terrorism coverage may kill the sale of a Times Square building priced at close to $600 million, and the Mall of America is at risk of default because of the terrorism insurance problem.

A major university has no coverage for terrorist incidents involving its laboratories. Its' research may have to be restricted at a potential cost of scientific advances. I add here that any terrorism insurance now written specifically excludes nuclear, chemical, and biological acts, the very type of assaults the public fears the most.

There have been, or soon will be, similar cases in every district represented on this panel. For all its urgency, the lack of terrorism insurance has remained a silent crisis. Owners have not complained publicly because they do not want to frighten the public or their tenants, investors, lenders, and potential purchasers.

In addition, policy renewals are staggered so many pre–9/11 policies will remain in effect for several more months. Those covered owners are terribly concerned by the current lack of adequate coverage and hope Congress will address the problem quickly.

In summary, these are the grim prospects if steps are not taken:

Sales of high value property will be few. Prices will drop. Property tax assessments and recording sales tax revenues will also drop and localities will face harsh budgetary choices.

I am inserting for the record an analysis by Cushman & Wakefield of likely lost tax revenues for New York City and New York State alone this year if Congress fails to act.

Owners in default will have to renegotiate, pay higher interest rates, and be compelled to take larger equity positions. Owners will not have funds to make needed improvements or do transactions. Construction and rehabilitation work for the trades will fall off. Lenders will loan less, declare owners in default, and maybe foreclose. Bank profits will drop.

The Senate must act on legislation now. Only the Federal Government can provide temporary backup terrorism insurance coverage. This initiative would not be a bailout for the insurance industry, but an effective defense to protect us, your constituents, from the economic aftershock of 9/11.

I would be happy to answer your questions.

[The prepared statement of Deborah B. Beck can be found on page 23 in the appendix.]

Chairwoman KELLY. Thank you, Ms. Beck.

We go now to Ms. Kramer.

STATEMENT OF LISA KRAMER, PRESIDENT AND CEO, FEDERATION OF JEWISH PHILANTHROPIES SERVICE CORPORATION

Ms. KRAMER. Thank you. Good afternoon, Chairwoman Kelly, Dr. Weldon, and Members of the subcommittee:

I am the President of FOJP Service Corporation. FOJP is a nonprofit membership corporation. We serve as risk management advisors to United Jewish Appeal, Federation of Jewish Philanthropies of New York and its beneficiaries, among which are six major academic medical centers, many long-term care facilities, and 110 social service agencies, community centers, Ys, and camps.

These institutions are at the forefront of providing cutting edge medical care, a broad array of mental health services, cultural, educational, and physical fitness programs, services for the elderly and for immigrants, camping and daycare for the young and the elderly, and employment counseling and training for those seeking jobs.

Services are provided on a non-sectarian basis to a population that reflects the diversity that New York State is known for, and often to people who have nowhere else to turn. Our facilities provide services and health care to millions of people year-in and year-out.

In its capacity as risk management advisor to these institutions, FOJP works with leading insurance brokers to procure lines of property and casualty insurance coverage that are essential to protect the institutions from liabilities and losses.

In May of 2001, through two of the largest insurance brokers in the world, FOJP began the process of marketing the renewal of the all-risk property insurance that covers loss of or damage to the real property of its client institutions, property valued in excess of $8.5 billion.

The renewal date was November 1st, 2001. In July of 2001, each of our brokers was assigned seven of the world's largest and most respected property insurers to which to market FOJP's coverage.

Sealed bids were due on September 17th. The brokers were actively in the process of seeking renewal quotations when the attacks of September 11 took place. An already hardening property casualty insurance market became a nightmare for insurance consumers.

FOJP stopped the competitive bidding process and used one broker to scratch and claw the worldwide insurance market for a renewal program. Before the November 1 renewal, FOJP's clients enjoyed property insurance limits of over $8 billion. Following the November 1 renewal, and despite the extraordinary efforts of one of the world's largest insurance brokers, 16 international insurance companies in combination provided a program with significantly less coverage and dramatically increased costs.

Most alarming, however, was that terrorism exclusions were added to the policies. Upstate hospitals, particularly in Buffalo and Albany, have seen their insurance limits drastically reduced, both their deductibles and premiums dramatically increased, and all had terrorism exclusions inserted in their policies as well.

The combination of significantly reduced limits and terrorism exclusions experienced by the FOJP program has become commonplace, posing a serious threat to the ability of non-profit health care and social service institutions to continue to provide the services that are so important to the poor, the aged, the sick, the disabled, and to those of us who are lucky enough to enjoy cultural and educational services without the burden of sickness or disability.

Each of FOJP's largest hospital clients has over $500 million in long-term debt, as well as more than $100 million in short-term loans for new construction. In the event that one single terrorist act even far below the magnitude of September 11 seriously damages or destroys any significant property in the United States, the effects of such a scenario could be far-reaching and devastating.

Lender agencies will realize that they are the insurer of last resort. Institutions will be unable to rebuild because of terrorism exclusions, and there will be defaults to private mortgagees and Government lenders.

Lenders may respond by requiring terrorism coverage before lending any additional money to similar institutions. The institutions will then face the choice of foregoing essential programs necessary to fulfill their mission, or paying exorbitant terrorism premiums for insufficient coverage.

A leading writer of terrorism coverage recently quoted the FOJP program a premium of over $4.2 million for only $50 million in coverage. Premiums of this size are simply not affordable in the current fiscal environment.

Leaving aside the day-to-day financial stress non-profit institutions bear in providing services, basic insurance costs are rising precipitously. There is no money in any budget to pay the premiums that are being quoted for terrorism coverage, if such coverage could be found at all. And even if the money could be found, the limits being offered are seriously inadequate.

If one of our insured hospitals were to be seriously damaged or destroyed by a terrorist act, $50 million in coverage would make but a small dent in the hospital's financial obligations and rebuilding costs.

The issue of insurance coverage for property loss caused by acts of terrorism is a serious one. Coverage is either unavailable or coverage that is available is inadequate in limits and unaffordable in price.

We need Congress to act, and to act quickly. Thank you.

[The prepared statement of Lisa Kramer can be found on page 24 in the appendix.]

Chairwoman KELLY. Thank you, Ms. Kramer.

We move now to Mr. Quinn.

STATEMENT OF KIERAN P. QUINN, PRESIDENT AND CEO, COLUMN FINANCIAL, INC., A SUBSIDIARY OF CREDIT SUISSE FIRST BOSTON

Mr. QUINN. Good afternoon, Madam Chairwoman, and Members of the subcommittee:

I appreciate the opportunity to be here today to discuss terrorism and its effects on the commercial real estate finance industry.

In 2002, Column Financial closed 549 individual loans for a total of $5.8 billion. The smallest loan was about a million dollars. The largest loan was $480 million.

Since 1/1, we have turned down roughly 9 to 10 loans valued at approximately $500 million only because they lacked terrorism insurance. Today we will not consider any loan in excess of $50 million without full terrorism insurance coverage. We will scrutinize all loans in excess of $20 million if they have any terrorism exclusions. And we have been anticipating we will receive all-risk policies on smaller loans. It is early in the year. We have not seen everything yet.

My competitors are also turning down loans because of the lack of terrorism insurance. High risk office buildings in high profile cities such as New York, Washington, Chicago, LA, will be extremely difficult to finance without terrorism insurance.

My fear is if another attack occurs, the insurance markets may shut down. To put the finance industry, the commercial real estate finance industry in perspective, our total outstanding commercial mortgage debt equals $1.7 trillion. Property taxes alone provide almost half of all Government funding, and more than 70 percent of the local tax bases throughout the country.

The real estate industry contributes approximately 11 percent of the Gross Domestic Product. 2001 was a record-setting year for commercial and multi-family loan production. New CMBS totaled over $76 billion in the U.S. alone.

Many of these loans were already in the pipeline before September 11th, but more importantly most lenders and originators continued to lend with the assumption that Congress would act and pass terrorism reinsurance backstop.

Loan production volumes for 2002 will be at risk if terrorism insurance coverage remains unavailable. During 2001, commercial real estate finance activity in Chicago alone was $10 billion. In Los Angeles, it was $10 billion. In New York, it was $12 billion.

This could represent a loss of business for lenders and developers. It could also represent a loss of future construction jobs and a current loss of transfer taxes to the localities.

Furthermore, pension funds and life insurance companies invest directly in commercial real estate as owners, and many of their investors, including average Americans who rely on fixed incomes, will see an industry downturn effect seriously adversely affect their retirement savings.

Currently there is a risk transfer occurring from the insurance industry to commercial business. Forty-six States have approved exclusions for terrorism, war, and military action and the use of nuclear, biological, or chemical material. This risk is being transferred to borrowers and to lenders, thus making the lenders the insurers of last resort.

If this situation remains, lenders will not be able to continue to make loans. I am here to say that lending capacity in 2002 is being dramatically affected by the lack of available terrorism insurance coverage.

My company is not the only lending institution affected. Several Manhattan high rise projects whose collective values equal about a billion dollars have lost funding because terrorism insurance could not be obtained.

Another company has established a policy to exclude funding consideration for all loans excluding $25 million without terrorism insurance. Many servicers of commercial mortgage-backed securities have concerns about insurance coverage on existing issuances on existing properties.

If the same insurance coverage is not available when policies are renewed, there is a possibility that loan covenants will be violated because the required all-risk coverage may not be provided.

Another major commercial mortgage lender with a $10 billion mortgage portfolio who originates large loans for securitization has decided to protect itself by requiring terrorism insurance on all new loans.

Borrowers frequently are unable to obtain the required terrorism insurance, making it impossible for the lender to close the loan.

The rating agencies are reacting to the lack of available terrorism insurance. Fitch & Moody's are in the process of creating new criteria to categorize this risk.

If Congress fails to pass legislation, these new guidelines could cause rating downgrades in new and existing deals.

In addition, special scrutiny is being given to the sort of small, run-of-the-mill properties in close proximity to these high profile properties because we don't know where the next attack is coming.

I am a commercial real estate lender. I am paid and trained to assess and price risk. But I am trained to deal with certain types of risk, and this is one I have no training to assess and deal with.

I can assess the risk of a K-Mart bankruptcy. I can assess the risk of a building burning down and collecting on insurance. But if I cannot assess the risk, and my borrower cannot obtain insurance, I cannot make the loan.

I submit that the time to act is now, before another terrorist incident occurs. Act now while we have the luxury of being able to give careful consideration of how a program should be crafted.

The need and purpose of Government reinsurance backstop is to stabilize and restore confidence to the markets. If and when another attack occurs, the Federal backstop will ensure against market disruption and panic.

I urge Congress to pass terrorism reinsurance backstop legislation, and I applaud the Financial Services Committee for taking the lead in this area.

Thank you.

[The prepared statement of Kieran P. Quinn can be found on page 137 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Quinn.

We move to Mr. Hunter now.

STATEMENT OF J. ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Thank you, Madam Chairwoman.

Chairwoman KELLY. Mr. Hunter, will you please push the button to turn on the microphone.

Mr. HUNTER. Yes. Thank you.

Chairwoman KELLY. Thank you.

Mr. HUNTER. Thank you very much. It is nice to be back before you.

You will remember that CFA was one of the early and strongest supporters of the bill that passed this subcommittee unanimously, or the Full Committee, and went to the floor of the House, because as I testified before the Senate I was very afraid of what might happen after January 1.

We did not support the ultimate bill because we thought the tort restrictions were too Draconian, but we did think that the Committee, particularly Chairman Oxley and Chairman Baker, did a great job here at the Committee level.

Because of the lack of Congressional action last year, we got to test whether the crisis that we feared would happen, and what would happen. There were many dire predictions, and we now can test did all these dire predictions come true? And the answer is, they did not.

Terrorism coverage, which was obtainable immediately after the September attacks, is becoming more widely available in larger amounts. Premiums are falling as more insurers enter the market. That is a quote from this morning's *New York Times*.

The world's largest commercial insurer, AIG, has just asked the Federal Government not to offer airlines war and terrorism insurance anymore because, as Mr. Greenberg put it, we as taxpayers do not want to compete with our own Government for business that the commercial sector can underwrite.

Ground Zero's cleanup and construction project at the World Trade Center has been written in a wrapup policy by Liberty Mutual.

The capital markets raised $24 billions in 10 weeks, which is breathtaking, said Alice Schroeder of Morgan Stanley. More money was raised in new capital than actually was paid out as a result of September 11th, when you consider taxes.

Lloyds of London says that new capacity has helped brokers obtain higher limits of $50 million to $100 million easy to obtain for good risks, he said, for terrorism. And by using capacity in Bermuda and the U.S. markets, brokers can obtain $200 million, the Lloyd's broker said. Lloyd's now comfortably places $200 million of coverage for any one building.

Insurers are developing ways to rate terrorism coverage, including new computer models which have been developed for that purpose. Some larger commercial accounts are using the Liability Risk Retention Act to cover the liability part of the terrorism risk, for example airlines are doing that in Vermont.

Captive insurance companies are forming to cover terrorism, for instance, for the construction trades. Banks are freely loaning money, and Mr. Greenspan this morning confirmed that. He said, quote: "To date there does not appear to be the case that there are any widespread problems. We have not seen any impact of that nature on the banks."

And I could go on with many, many more positive things. So CFA undertook a major study of the insurance market. We found that the insurance market is wealthy and overcapitalized. High rates are a serious problem for mid-sized and larger commercial insureds, but that is much more related to the economic cycle of the insurance industry than terrorism.

The larger firms are finding alternative ways to deal with the problem such as self-insurance and creation of captives, and even securitization of risk.

The rate problem is caused by their classic turn in the economic cycle, but the hard market is anticipated to be short because of the excess capital in the insurance industry.

Banks are freely loaning money. GAO has today released its report. It points to real estate and commercial lending as potential trouble spots. It cited ten examples of problems, eight of which are in these areas. The others are terror targets, a mall in an airport. Of the ten, four are located in New York, maybe more, at least four.

CFA agrees there are problems developing in certain areas, but as GAO says, quote: “The extent of negative economic impacts of a lack of terrorism coverage is not yet clear. Ultimate impact on the economy cannot be gauged.”

This is not to say there are no problems. High prices are a serious problem because of the cycle turn. In the mid-1970s and mid-1980s, we experienced crises like this. The mid-1980s crisis was much worse than the one we are currently in. You may remember that *Time Magazine* had a cover that said “Sorry, America, Your Insurance Has Been Cancelled.”

The price increases in the hard market caused by this cycle term began in late 2000. The terrorist attack sped up these price increases into what many seasoned industry analysts see as price gouging today. But terrorism did not cause the price increases.

What should Congress do today?

One, I think you should not rush into passing a full backup bill. You should continue to have the GAO review what the problem is, and to look at the problems and see what the limits are. Real estate trophy risks, other trophy targets, particularly in New York City. You should document that.

Congress should be prepared to act if an event occurs quickly, just as you did with the airlines. GAO raises the important question of how to deliver payments, but there are ways to do that. Even the insurance companies do not have adjusters to cover say major earthquakes, and there are services available for ways to deliver money if you decide to do something after the fact.

You may decide to target the ultimate bill, if there is one, to the specific risk. the terrorist targets and the trophy risks. Those are the problems. So maybe something like a coverage only in excess of a $500 million retention per entity.

Big business wants an all-industry bailout rather than a specific backstop. I don’t think they need it.

Second, if any Federal backup bill is required, the House version is the right way to go in terms of a payback mechanism. We totally agree with that.

Third, we think you should consider developing private sector alternatives. For example, expanding the Liability Risk Retention Act to cover property insurance. Why shouldn’t the wholes of these aircraft be able to be covered by the airlines, just like they are going to cover their liabilities? The Risk Retention Act is a very important tool to give alternatives to the private sector.

And finally, any bill that does pass you have to address rate gouging. If you pass a backup bill, it would be foolish to not have a price reduction as part of the bill. I would be happy to answer questions at the appropriate time.

[The prepared statement of J. Robert Hunter can be found on page 142 in the appendix.]

Chairwoman KELLY. Thank you, Mr. Hunter. I read your testimony. I found it very interesting, but it certainly seems to me you may not have interviewed the other panelists.

We move now to Ms. Schroeder.

STATEMENT OF ALICE D. SCHROEDER, SENIOR U.S. NONLIFE EQUITY INSURANCE ANALYST, MORGAN STANLEY.

Ms. SCHROEDER. Thank you. Good afternoon, Madam Chairwoman and Members of the subcommittee:

I appreciate the opportunity to appear before you today. As an equity analyst, I am an observer of the industry, but I also represent the owners of the companies who supply capital to the industry, and I am the only representative of the owners of the insurance companies here today.

The risk of terrorism which was formerly borne by insurers is now being distributed more broadly throughout the economy. This afternoon the financial institutions research team of Morgan Stanley issued a report on this subject.

We have analyzed the real estate, banking, asset management, and insurance industries to discuss and understand how the risk has shifted out of the insurance industry toward other sectors of the economy.

Collectively we estimate that there are approximately $12 billion of assets exposed in the commercial area in the United States, excluding homes and personal assets—excuse me, $12 trillion, which obviously greatly exceeds any capacity that the insurance industry could possibly hope to provide for terrorism coverage.

There is no possible way the insurance industry could deal with that.

Lenders have shown varying degrees of concern about the lack of coverage in their portfolio, depending on their business mix, with many beginning to demand coverage. Others, we are aware, have begun to ask borrowers to explicitly self-insure, shifting the risk directly to their customers.

Property and business owners are seeking insurance coverages, but they are generally not finding it for the higher risk properties, and for large groups of employees for workers compensation.

Many, however, still have coverage which will expire later in the year. And those who have already lost coverage appear to have varying levels of concern depending on how they assess their own risk.

Mathematically, the effects of customers and insurers to avoid the risk collectively does not protect the economy against terrorism. The risk has only been redistributed.

We think you need to understand the assumptions that are being made by participants in the economy in thinking about this, as we have discussed them with many people.

It appears that many are assuming that if there were another event, the Federal Government would provide essentially unlimited post-event funding; that the funding would be in proportion to economic losses regardless of insurance coverage; and that any capital destroyed, any debts owed, and any insurance claims owed would all be paid by the Government.

It also appears that some may be assuming that any further attacks would be an act of war. In other words, that insurance coverage might not even apply.

We also believe there are other reasons why there has not been more panic and visible economic disruption, including the fact that insurance policies renew throughout the year, and that many people are assessing their individual risk odds as low. But it is important to separate panic behavior from real economic disruption.

As analysts, we deal in facts and data. And the economic disruption is the fact that significant risk has been shifted from insurers to their customers. That is a fact. It is a simple economic fact that we believe cannot be disputed.

Even if every exposed party retains its own risk collectively and has no complaints about doing so, the risk remains in the economy and has not been addressed.

We believe, however, that complaints about the disruption will worsen over time because as more insurance policies renew, more coverage will be lost. And the limited insurance capacity that is available is being used now by those whose coverages are expiring early in the year. So you have some inequities that may result from that.

The insurance industry will develop over time some additional capacity for terrorism coverage, but it will fall far short of the requirements.

For example, the $20 billion of capital that was raised by the industry last fall was all raised by investors for the reinsurance industry, and that money is not being used to cover terrorism, and those investors certainly had no intention of covering terrorism risk.

The rating agencies commented that there was a rating threat here, but so far there have been no downgrades. We expect that over time that may change.

And finally, institutional investors currently are in a state of ignorance, not seeing disclosure. They would certainly like to know more about their investments and what the status of the equities that they own have.

The SEC is considering this issue, but we are certainly in favor of disclosure.

So to sum up here, a brief perspective on the insurance industry. From the point of view of an equity investor, insurance companies generally destroy rather than create value for their shareholders.

They compete for market share ferociously and are quick to underprice their product, given the opportunity. From our perspective, customers get an extremely good deal subsidized by shareholders, and if insurers could gain market share by covering terrorism, we believe they would be doing it right now if there were any way to underwrite terrorism successfully. We simply do not believe there is.

The shortage of insurance capacity, along with the simple and obvious mathematics of terrorism losses, indicate to us that there is a problem here that needs to be solved. So on behalf of the shareholders who provide critical risk capital to this industry, we urge your careful consideration of these issues.

One thing to especially keep in mind is whether the shareholders will recapitalize the industry if there is another event.

Thank you.

[The prepared statement of Alice D. Schroeder can be found on page 171 in the appendix.]

Chairwoman KELLY. We thank you very much, Ms. Schroeder.

Mr. Mair, I would like to ask you a question or two.

As the representative of the commercial consumers, the businesses most directly affected by a lack of terrorism coverage fall into your category, and I wonder if you could explain to us the risk transfer that is occurring from insurers to the businesses and the vulnerability of commercial policyholders to another terrorist attack from your perspective if they fail to obtain terrorism coverage.

Mr. MAIR. As I said, Madam Chairwoman, the RIMS membership includes approximately 84 percent of the Fortune 1000, and on the smaller end, over 900 businesses with less than 500 employees.

Those small organizations rely on insurance coverage to recover from catastrophe. In the absence of that, those companies simply do not have the resources to reopen their doors again.

By example, in the middle sector in my organization, every dollar that I pay for insurance is a dollar that the U.S. Olympic Committee cannot use to train athletes. It is a dollar that a company of my size cannot use to pay an employee to pay for health benefits.

On the uppermost end, these are companies that have the ability to retain more of that risk, to spread more of it across multiple properties, but still yet those are going to have an impact should those losses materialize, or should those higher costs continue to be absorbed by those organizations.

Simply put, those are going to be transferred through the chain, through the supply chain, to the ultimate buyers, to the consumers.

Chairwoman KELLY. Thank you.

Mr. Mair, your fellow panelists here, Mr. Hunter, in his testimony wrote that larger firms are finding alternative ways to deal with the problem such as self-insurance, creation of captive insurance companies, and securitization.

You represent the companies you spoke of, the Fortune 500 and Fortune 100 companies, and a lot of smaller businesses. Do you find this to be the case? Or are there large companies that are in need of this Federal legislation?

Mr. MAIR. Let me answer those questions in reverse order.

There are clearly large companies that need this legislation. It is dynamic, it is required, and it is required today.

The same companies that are banding together to form captives, to use alternative risk transfer vehicles, still look to the reinsurance markets. They are not banding together and creating those captives for unlimited losses. They are all capped within working layers of loss that are predictable and understandable and fundable.

Where the reinsurance industry has pulled itself away, where it has left, they are left with the fullness of that liability. And none of them, even the largest, have the ability to absorb that on their own.

And by the way, I really disagree with something. You mentioned Mr. Hunter's testimony. I have to tell you on behalf of the consumers of insurance, I really strongly disagree with the Consumer Federation of America's assertions. I think they have looked at the right fact patterns, but at best hit the outer ring of the bullseye.

Chairwoman KELLY. Thank you, very much.

Ms. Schroeder, how many investors do you think are aware that their investments may no longer be protected by terrorism insurance? And if the Senate fails to act, is this not putting both the investors and the lenders at a significant risk?

Ms. SCHROEDER. Yes. Investors are in a state of ignorance right now because they know there is risk, but there is no disclosure of lack of insurance. So there is a creeping miasma of risk out there and concern, but they don't know which companies to apply it to because, while insurance coverage has been withdrawn, they do not know yet if the policy has expired for the company that they happen to own, for example.

They know that risk is rising, and they are. generally speaking, aware. There are certainly varying levels of awareness among investors however, and we believe investors are becoming more aware of that. For example, Lehman and Morgan Stanley this week have both issued major reports on this matter, the first to be issued.

So we expect that over time investors are going to become more and more concerned.

Chairwoman KELLY. Thank you.

Ms. Beck, why do you think some real estate transactions are occurring in the face of the unavailability problem?

Ms. BECK. Well, I know of one in Chicago that took place and was sufficiently interested to find out how, since it was a large transaction. And I did call and found out that the owners have a blanket policy in effect until early summer. Because of their relationship with the insurance company that had provided the blanket, they were able to include the new purchase in the pre-9/11 existing blanket policy.

But, as I mentioned on renewal, now there is no blanket coverage being provided for large portfolio owners. I might also, if I may ask your indulgence, comment on Mr. Hunter's analysis of the situation.

I wish I were as sanguine as he that if we waited long enough the free market would come up with a solution. I just wonder—and this may be a little unfair, Mr. Hunter—but I just wonder if you were hanging over a cliff, if you would like to wait there while someone created a business to rescue you.

Chairwoman KELLY. Thank you, Ms. Beck.

Mr. Hunter, do you want to attempt an answer here?

[Laughter.]

Mr. HUNTER. Sure. Well, actually I think there are some problems. I said that. And I think the Congress needs to reconsider how to address the real problems that may exist in certain limited parts of the economy. That is just not the kind of situation that was predicted; it is not happening; and you cannot create it. It is just not there.

Chairwoman KELLY. Well, Mr. Hunter, it has been 6 months since 9/11——

Mr. HUNTER. And one-third of the direct insurance is now written because 25 percent of the commercial business comes up on January 1 of the direct business, not the reinsurance. Seventy percent of the reinsurance expired on January 1, but 25 percent of policies attached on January 1, the direct policies, and since then about—so we're at about a third of the policies out there and we're not hearing anything.

Ms. BECK. May I comment?

Chairwoman KELLY. Ms. Beck, yes.

Ms. BECK. Thank you, Madam Chairwoman.

I think that when Mr. Hunter says that the policies have been written, he is not aware perhaps that acts of terrorism have been excluded from coverage.

In the States that are not covered by the ISO exclusion, which permit States to allow insurers to exclude terrorism coverage—in the States that still are not approving that exclusion, you have 35 percent of the commercial property market.

In our market in New York, I know for certain that several billion dollars worth of real estate is either grossly under-insured for terrorism, or has had no coverage for terrorism in those same 3 months. And I know that in a survey that you did, Mr. Hunter, you may not have had access to nor would it necessarily have been disclosed to you, because, as I mentioned in my testimony, property owners are frightened to make public this fact, either to potential terrorists or to their investors or lenders or anyone else, for that matter, including their tenants who also might be frightened knowing that there is no coverage for acts of terrorism.

Furthermore, anybody who has renewed insurance is not getting coverage for the very risks that I think our Government is most concerned about: bioterrorism, chemical or nuclear terrorist acts.

I do not question that what you have in your study is correct, but it is missing are some of the most critical underlying facts affecting the large commercial properties.

Chairwoman KELLY. Ms. Schroeder, did I see your hand on that?

Ms. SCHROEDER. Yes. I was just going to add that there has been some evidence from the NCCI which runs the Workers Compensation Pool that since January 1 it has become very, very difficult for large employers to buy workers compensation because you cannot exclude terrorism coverage from that product. And that is a very significant shift since January 1, which would indicate that the lack of reinsurance coverage is what is triggering the primary companies to stop selling the product to large employers.

Chairwoman KELLY. Thank you.

I am out of time, so I am going to turn to Dr. Weldon.

Dr. Weldon.

Dr. WELDON. Yes. I have a question for Mr. Hunter. Those tort provisions, you referred to them as being Draconian, I would like you to amplify on that just a little bit, because I thought if we were going to be putting basically the Treasury of the United States at risk for coverage for these things, it was reasonable to place some restrictions on the trial bar to raid the Treasury.

And I am just a little shocked to hear that from you. You know, you go to buy a ladder at K-Mart or Wal-Mart, it is about twice the price it should be because of the insurance on the ladder and all that.

So from a consumer perspective, can you explain where you are coming from on that issue?

Mr. HUNTER. Sure. Well, I supported tort restrictions as it passed this Committee. There were restrictions.

Dr. WELDON. OK.

Mr. HUNTER. And I supported that.

Dr. WELDON. So when the question was before the Committee——

Mr. HUNTER. It went to the floor and they tacked on a whole new set of much broader restrictions that went way beyond just terrorism, and I was opposed to that. I thought it was—first of all, it was non-germane, and second, it was Draconian.

Dr. WELDON. Ms. Kramer, did I understand your testimony correctly that you now have a lot of exposure; that you just cannot get insurance?

Ms. KRAMER. Well, that is absolutely right. We cannot get coverage for terrorism. And that applies not only to the hospitals and agencies in the FOJP program, but as I mentioned we've talked to the hospitals in Upstate New York and I know from personal experience hospitals outside of New York City and New York State are experiencing the same thing.

I want to just comment for a moment on both what Mr. Mair said and also what Mr. Hunter said. Mr. Mair made the point that the problem may be up at the reinsurance level. We have a captive, but that captive is in no way, shape, or form able to subsidize and take care of terrorism coverage.

When we go to our insurance companies, the primary carriers happen to be excess and surplus lines companies and they do not even need approval. They do not need the approval of the Superintendent of Insurance in New York for excluding terrorism.

Then you move to the reinsurers and their prices are, when you can get a little bit of coverage, are exorbitant. The hospitals and the agencies in our program, the hospitals particularly, are cash-strapped. They have only got a few weeks of cash on hand.

In the September 11th attack, two of our hospitals were seriously affected and, fortunately, because of our program pre the last renewal, had coverage for major business interruption losses.

In addition, our agencies throughout the city who had to gear up to take care of victims of September 11th and their families, their services were also interrupted. So you are talking about thousands of people in the City of New York who are not getting the health care services, or access to it, let alone social service agency services all because of a terrorist act. And that one was covered. The next one is not.

Dr. WELDON. Does your organization consider itself at higher risk to be targeted in light of the virulent anti-semitic sentiments of these terrorists?

Ms. KRAMER. Well, bear in mind that the agencies and the hospitals are non-sectarian, and therefore offer their services to people of all walks of life, all religions, races, and so forth.

Dr. WELDON. But the name on the door is——

Ms. KRAMER. The name on the door of my organization, FOJP Service Corporation, of course, has Federation of Jewish Philanthropies in the title. But the hospitals and the agencies are not necessarily, you know——

Dr. WELDON. Labeled that way.

Ms. KRAMER.——labeled.

Dr. WELDON. OK. Mr. Hunter, do you want to comment on this situation? We have got a major charitable organization in this country that is exposed.

Mr. HUNTER. Yes. Obviously I think the major kinds of risks that are exposed, particularly if they are targets, I think Congress should consider if there is some role for Congress maybe coming in at the high level as an excess carrier, because I think you can get lower levels of terrorism coverage for terror.

But I do not think you need to take that and then expand that to a general bill the way the current bill stands as it passed the House. I do not think you need that kind of general coverage anymore. I do not think it is necessary, based upon what we are learning.

Dr. WELDON. I see some people who want to respond to that.

Ms. BECK. I would like to mention that I have been discussing the issue with representatives of another major religious organization that is not affiliated with Ms. Kramer's, but has many, many properties throughout the country. I have given its name to the General Accounting Office, because I just learned on Monday that they were prepared to talk to the GAO. Unfortunately, my message did not get to the staff in Chicago. The insurance dilemma is a widespread problem for religious institutions of all denominations across the country.

I think that we are very fortunate that Ms. Kramer is here today, because in her example she had insurance that was to be renewed, I believe you said on November 1st, and that is really germane here, because we have this staggered schedule of renewals coming up.

And there are still a large number of entities that have insurance written before 9/11. But what you are hearing today is analagous to the Galapagos Islands, tips of volcanic mountains. In the ocean, if the Pacific starts receeding you are going to see this problem in stark relief—and it will worsen if Congress does not act—creating some reinsurance mechanism must be done, and done very quickly.

Mr. HUNTER. You know, Mr. Weldon, if that is true that there are many religious institutions with this problem, that is a classic example of why you would want to look at the Risk Retention Act as possibly expanding it. Because the Risk Retention Act which helped solve the liability crisis of the mid-1980s and the mid-1970s, is limited to liability insurance. And it allows groups to get together all over the country and form to either buy insurance as a group, or to self-insure themselves.

And it is a very good tool, because it offers alternatives. It also kind of scares the insurance companies into making more reasonable bids. And it is something that should be looked at, because Congress in both the last crises we had like this used that tool, and I think it would be a perfect tool if you expanded that to property and workers comp here.

Dr. WELDON. Did you want to comment on that, Ms. Schroeder?

Ms. SCHROEDER. Yes. I just do not view that as a feasible solution because the kind of small events that a risk retention group could handle, you could already buy adequate coverage for.

The kind of large events that you need coverage for, no risk retention group could possibly capitalize. So economically I think it is a good idea, but I think you already have capability to cover those kinds of risk.

The insurance industry is happy to provide capacity for small, reasonable acts of terrorism that they have the capacity to cover. It is the large events that they do not have the capital for. And if the entire insurance industry does not have the capital, how can a risk retention group made up of non-profits do it?

Ms. BECK. And that is our point, as well. We were approached by several hospitals as though we had the capital to invest in starting up a risk retention group, and there might be one or two hospitals in the New York State or New York City area that have some capital to throw at this problem. But these are, as I said, cash-strapped institutions. They are not-for-profit and they cannot afford to self-insure or go into a risk retention group, and there is no affordable coverage being made available from any of the insurers or reinsurers.

Our concern is that, as the cost of this coverage has become prohibitive—covering the expense takes money as it is transferred to an operation that previously did not cost near this much in terms of funds.

That situation is simply going to raise the cost of health care in New York and elsewhere. How else are you going to pay for the physicians and the services?

Mr. MAIR. Mr. Weldon, if I might, before you conclude your time, Mr. Hunter cited three sources in saying to you that there is coverage available. He cited today's *New York Times* in which Joe Treaster indicated that there was coverage widely available at reduced costs.

I spoke with Mr. Treaster in an interview for that article yesterday, and what he indicated to me was he was able to find one program in which the cost had gone from 20 cents on the dollar to 5 cents on the dollar.

With all due respect to Mr. Treaster, you can sell me the Hope Diamond at half its value and I still cannot afford it. It does not become available.

Mr. Hunter also made reference to Lloyd's, and the fact that coverage was available there. Lloyd's is beginning to exclude fire-following coverage, an issue that is growing in 30 States now in which that coverage remains even following the terrorism exclusion.

That does not suggest to me that coverage is available.

And he cited, as well, Hank Greenberg, Chairman of AIG, saying that on the aviation side that Government need not do anything. Well, in that same *New York Times* article, Mr. Greenberg is cited as saying that Congress not acting is like going to war without an army, and urged the Congress to act.

I concur with Mr. Greenberg in that respect. And again, thank you for allowing me to interrupt.

Dr. WELDON. By the way, the way I deal with the *New York Times* is that I just don't read it.

[Laughter.]

Dr. WELDON. If the Chairlady would just indulge me for one little question, could you, Ms. Schroeder, could you just explain to me how insurance companies destroy equity?

Ms. SCHROEDER. Yes. How they destroy equity is they sell the product too cheaply. Insurance is a derivative, and by that I mean that the premium they charge is a fraction of the risk that they take on.

So when they underprice the product, they can destroy massive amounts of value. Over the last 10 years, insurance companies have earned on average on their capital 8.5 percent, which is about what a corporate bond would earn. And that is on average.

That is during a period when they got big windfall gains from being invested in equities. And if you took those windfall gains away, they would have lost money.

They also got big windfall gains from basically deflation of their costs that were nothing that they did.

The risk that an investor takes on from investing in a stock, they need to get paid for that risk more than a bond. So value destruction is if you only get paid what you get for owning a bond when you're taking the risk of an equity, and especially when that return you did get came from something that was an accident like the equity market, not from the basic business of selling insurance.

The insurance companies typically lose something like 10 cents for every dollar of premium that they sell on the basic business of selling insurance. So customers get a $1.10 worth of claims and expenses for every $1 they give to the insurer for premiums.

Dr. WELDON. Thank you, very much. I will go sell all my insurance stocks immediately.

[Laughter.]

Ms. SCHROEDER. Most people do.

[Laughter.]

Dr. WELDON. Just kidding about selling those stocks.

Mr. HUNTER. They're up at a rate of 15 percent since September 10th.

Ms. SCHROEDER. And where are they from 1998?

Chairwoman KELLY. Thank you very much, Dr. Weldon.

I want to go to Ms. Kramer just for a second. Ms. Kramer, I want to tell you that because of the area that I represent in New York, I am well aware of the Federation of Jewish Philanthropies and all of the good work that you do. You are all over my District doing wonderful things, which is why I am so concerned about your risk.

According to the GAO report, that exclusion that is being used by the insurers excludes not only terrorism but also the commission of any dangerous or violent act intended to intimidate any segment of the population, or to express any opposition to a philosophy or ideology.

I am concerned, ma'am, that you are able to get insurance to keep on doing those good works in the face of potential for criminal activity for bioterrorism, things like that.

I would like you to speak to that, because I think that your risk is increased in that regard.

Ms. KRAMER. Well, let me say two things.

First with regard to the hospitals in our program, we have more than just Jewish hospitals. Right in New York City, you know, we have got hospitals from other religious affiliations as well as I commented on Upstate New York.

Now second, we have already encountered not only difficulty but it has been impossible to get bioterrorism coverage. So what do we see? We see hospitals all over the United States preparing their disaster recovery plans so that they can treat the public in the event of a bioterrorism attack. But who is there for them?

And so at the cost of treating the public, there will be no coverage and no money available to rebuild or to cover property that is damaged, or people's lives and health that is injured, and that is the problem. Where will the money come from for them?

So my concern is that we have already seen and encountered the difficulty. We cannot get bioterrorism coverage.

Chairwoman KELLY. So as long as the Senate does not act on this bill, you are continuing at risk?

Ms. KRAMER. We are.

Chairwoman KELLY. And so are the people, the women, the children, the families that you serve?

Ms. KRAMER. All of those segments of the population are extremely vulnerable right now, and that is why we think it is important that Congress act now as opposed to putting this off any longer.

Chairwoman KELLY. Thank you very much.

I just want one final question to you, Mr. Quinn.

Mr. Hunter says that there is little if any problem with loans in the current market for terrorism insurance. I would like you to tell me if you agree or disagree with that statement.

Mr. QUINN. I strongly disagree. I think he made a comment earlier that banks are lending. Banks make all types of loans—consumer loans, lines of credit to buy inventories and to finance accounts receivables. The world that I live in lends on commercial properties, a specific loan on a specific asset.

It even goes broader than that. The financial markets that we operate in rely on confidence. Insurance is a critical component of the collateral that I lend on and the confidence behind the industry that I work with. It is vital to everything that we do.

Chairwoman KELLY. What effect would another terrorist attack have on your business and on your industry if Congress fails to pass this terrorism insurance protection?

Mr. QUINN. If I cannot get insurance on these properties, I cannot make loans. I am the permanent lender. I am the one who takes the construction lender out, or the bank loan out. All these loans will back up at the banks and they will be unable to make any new loans, and construction will grind to a halt.

Chairwoman KELLY. As I would assume, Ms. Beck, real estate transactions would also, because the banks cannot do the loans on those, either.

Ms. BECK. Well, we are already seeing that. But I think that, while lenders are making commitments on a lower loan-to-value ratio now than since the early 1990s when they had to foreclose on a number of properties because of our economic decline at that time, I think lenders will face a real problem if owners cannot get the terrorism insurance and the building is, in fact, destroyed. The lender generally having a non-recourse loan will be totally out-of-pocket for that particular piece of property.

I hope we will not have any further terrorism incidents. Were that so, the FISC will be protected even with legislation passed by the Congress, because we comtemplate backup insurance in the event of an attack. FISC is not saying, "We are going to hand out money now."

This is a very important distinction to make in talking about this subject. We have a Financial Committee at the Real Estate Board of Lenders and Mortgage Brokers that meets monthly. From what I am hearing, since January first, no large loans have been made on either renewals or on transactions.

This is very, very serious. I cannot promise that we can get you all the data, but we are hearing in our private meetings that this crisis is just going to continue to get worse and worse. Without congressional action, you can expect a domino effect that will be increasingly evident as the months pass.

Chairwoman KELLY. Well, certainly there does seem to be a concern when you have the Administration confirming the likelihood at or near 100 percent of our having another terrorist attack. There certainly is a concern.

There are, I am sure, questions from other Members who have not been able to get to this hearing today. I want to make a note of that and say that, without objection, I am going to hold the hearing record open for 30 days so that Members can submit written questions to the witnesses and we can place their responses in the record.

I want to especially thank this panel for honoring us with the time that it took for us to get through this hearing, and for being so very patient with that delay and with the quality of your answers here today.

This panel is excused with the subcommittee's great thanks. With that, this hearing is adjourned.

[Whereupon, at 6:20 p.m., the hearing was adjourned.]

A P P E N D I X

February 27, 2002

Statement of Chairwoman Sue Kelly; House Committee on Financial Services Subcommittee on Oversight and Investigations Hearing: How much are Americans at risk until Congress Passes Terrorism Insurance Protection?

February 27, 2002; 3:00 p.m. 2128 Rayburn

On September 11 our world fundamentally changed with the cowardly acts of a handful of terrorists. We all carry with us the memories of the destruction of that day which deprived families of loved ones, people of their jobs and a nation of one of its greatest landmarks. In addition, the losses of September 11 represent the largest single hit to our insurance industry in history. Since then our insurance markets are facing a new reality. Insurers are being asked to insure terrorism risk, when they have no realistic way to determine the fair price for that risk or, in the vast majority of cases, being able to obtain any reinsurance for it. This risk is one which no one ever anticipated. Moreover, no one can presently calculate the proper odds for where or when the next attack will occur. We do know, however, that our government officials believe that we should expect additional and costly attacks. Consequently, the vast majority of insurers have been loath to cover terrorism, especially for major buildings, factories, or gathering places. Where terrorism insurance is available or is required by law, insurers must charge high premiums for it and offer very limited capacity to protect against the risk of insolvency.

Today, nearly six months later, we continue to discover further repercussions from the acts of terror on New York and Washington. One such symptom is the pervasive risk transfer that is currently occurring from reinsurers to insurers to American businesses, leaving such businesses vulnerable to future terrorist attack. I think the GAO put it best in their report:

"Since the September 11th attacks, the key dynamic taking place in the insurance industry has been a shifting of the risk for terrorism-related losses from reinsurers to primary insurers and then to the insured. Reinsurers and insurers have begun shedding their exposure to terrorism risk as insurance contracts have come up for renewal, leaving policy holders increasingly exposed to losses from a terrorist attack."

The GAO goes on to say:
"Large companies, businesses of any size perceived to be in or near a target location, or those with some concentration of personnel or facilities, are unlikely to be able to obtain a meaningful level of terrorism coverage at an economically viable price."

The focus of the GAO's inquiry was on the availability of property/casualty insurance and reinsurance. That is clearly important. But we also need to consider whether there have been similar detrimental effects with respect to terrorism coverage in the group life insurance area, and I hope we can get some enlightenment on that question as well.

It is clear the current lack of terrorism coverage acts as a chill factor restraining our economy, which is struggling to recover from a recession. Businesses, particularly in cities and near targets, seeking to build are being required to carry terrorism insurance; however, I am informed that there is little or no terrorism coverage available and hence some new construction is being stopped before it can start. This is causing the loss of new jobs at a time when creating jobs should be one of our highest priorities. In short, the Senate leadership's failure to act on terrorism insurance legislation is imposing a fear tax on America, costing real jobs when the country is trying to pull out of a recession.

In addition, since the Administration says that another terrorist attack is extremely likely, we must plan for how the government should react to such an attack now, not after another attack. We have learned countless lessons from September 11th on homeland security and distributions from September 11 charities, which could have avoided so many problems with a little more planning before hand.

Acting now will preserve a private market mechanism to provide terrorism coverage, capital, and a claims processing system. Waiting until Americans suffer the next terrorist attack to respond is irresponsible, inefficient, and will ultimately cost the government much more than taking responsible action, now. Victims will most likely suffer months of additional delays as Congress scrambles to create a bureaucracy to determine which victims get compensated in what amounts. This can be especially harmful to small businesses, which cannot afford to wait months after a tragedy while Congress decides whether and how to respond. As a former small business owner this concerns me greatly.

Under the leadership of Chairman Oxley this committee acted quickly last year to pass H.R. 3210, the Terrorism Risk Protection Act to protect the U.S. economy, its businesses, and its workers from the negative effects that are materializing today. I sincerely hope that the Senate leadership will act quickly to avoid a potential calamity.

Today, we will hear from a list of very distinguished witnesses to gain a better understanding of how the lack of Federal legislation has and will affect commercial consumers, builders, lenders, investors, workers, schools, hospitals, public entities, and private institutions. I would like to thank all of the witnesses appearing today or submitting written testimony for the record.

Prepared, Not Delivered

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Oversight and Investigations

"How Much are Americans at Risk Until Congress Passes Terrorism Insurance Protection"

February 27, 2002

We are here today to revisit an issue that we spent considerable time and effort on last session: the need for terrorism insurance protection for American consumers and businesses. After the Senate failed to act on our bill last year, we started working with the Administration and the GAO to assess the ongoing need for Federal legislation. We have concluded that the legislative imperative is still very real and continues to grow day by day. While the sky is not falling, it is certainly cracking around the edges.

American businesses, lenders, builders, workers, and investors all rely on the risk-spreading protection of a properly working insurance market. At least in the short term, this market has not and can not protect our markets without a Federal backstop.

We are now facing a steady risk transfer from reinsurers to primary insurers to consumers. Americans are becoming increasingly vulnerable. Many businesses are unable to get meaningful terrorism coverage, putting their operations at risk. Banks have made loans on collateral with inadequate coverage. And American investors have their savings tied up in projects and companies that are no longer fully insured.

In addition to this risk transfer, the economy is suffering from the lack of available terrorism coverage. Our witnesses today will testify that banks are not lending, real estate projects are not occurring, and expansion plans are being dropped. This means fewer jobs for Americans as we attempt to climb our way out of a recession. As the AFL-CIO and the Financial Services Roundtable recently wrote in a joint letter: "Today, the ensuing dislocation is affecting financial services firms, which finance projects. Tomorrow, it will be union workers, the builders of commercial projects, whose jobs are at risk."

The need for Congressional action has rarely been clearer. While insurers may be able to diversify over time to address most market needs, Americans cannot afford to be left vulnerable during this transition. There are almost no costs for Congress to act now. But the costs of not acting could be enormous.

The passage of terrorism risk insurance legislation now is an insurance policy for the U.S. economy. It is protection against the likelihood of terrorist attacks in the future – a threat that we all know is far too real. But like any other insurance policy, you must purchase your coverage BEFORE a tragic event occurs to protect yourself and your family. We will hear from various members of this country's "family" today, and they have a common refrain: that we in Congress must pass terrorism insurance legislation now to give them the protection they need. The House has heard their plea. I hope the Senate Leadership is listening.

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U.S. Congresswoman Judy Biggert
Opening Statement-Oversight and Investigations Subcommittee
How much are Americans at risk until Congress Passes
Terrorism Insurance Protection
February 27, 2002

Madam Chair: January 1st has come and gone, and, as predicted, a major change in insurance and reinsurance coverage is taking place that threatens our economy. Months ago, in the wake of 9-11, many members here predicted what has now, in fact, occurred: most reinsurance renewals now *exclude* coverage for terrorism, and most primary insurers will *exclude* terrorism coverage in the coming months.

It is because we anticipated this outcome that we on this Committee and the full House acted quickly late last year to pass a terrorism insurance bill.

But, sadly, our Senate colleagues did not take quick action. They did not take any action -- not before the January 1 renewal deadlines, and not since January 1. Unfortunately, as with so many other issues during this Congress -- when it comes to terrorism insurance and reinsurance coverage, our colleagues in the Senate seem to have their heads buried in the sand.

It is my hope that some of our Senate colleagues might be motivated by the comments made this morning by Federal Reserve Chairman Alan Greenspan, who did not mince his words. He said, quite simply, that passing a terrorism insurance bill is critical to stabilizing the marketplace. Chairman Greenspan is not alone in this view. Even the General Accounting Office has noted that, without a terrorism insurance bill, there will continue to be a significant drag on our economy.

Unfortunately, this burden has fallen particularly hard on one segment of the economy that can least afford to live without terrorism coverage -- our public self-insured risk pools. These risk pools – more than 125 operating in forty-one states – help local governments, school districts, housing authorities, and other public entities to provide necessary insurance protection.

They provide coverage to those most often at greatest risk – police officers, firefighters, and emergency medical personnel – as well as teachers and students, municipal employees, and many others. We all know that these public entities cannot absorb the costs of terrorism risk across their membership base.

I have heard from several risk pools in my state that are desperate for help. In Illinois, the Assisted Housing Risk Management Association (AHRMA) no longer has coverage for an act of terrorism. That self-insured pool covers public housing authorities across my state.

The Illinois School District Agency (ISDA), a self-insured risk pool covering public school districts in Illinois, has been told that its July 1st renewal will have a terrorism exclusion.

And the Department of Insurance in Illinois is now allowing the exclusion of terrorism coverage in new and renewal policies. So my state becomes one of 45 states that are allowing such exclusions to be written into policies.

The need for Congress to act has never been greater.

Large self-insured pools and individual self-insurers such as the City of Chicago will pay as much as four times their expiring premium to buy the additional coverage necessary in the coming year.

Make no mistake – public self-insured risk pools are more vulnerable than other entities. They provide enormous savings to taxpayers.

In choosing to do nothing, the Senate threatens to undermine a system that our policemen, firemen, schoolteachers, tradesmen, assembly line workers, commercial property owners, and others depend on. Without a federal solution, our workers, businesses, and public institutions will suffer. I hope that the members of this panel will not hesitate to place the blame where it rightly belongs – with the do-nothing Senate.

OPENING STATEMENT OF
LUIS V. GUTIERREZ
RANKING DEMOCRAT
SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS
"HOW MUCH ARE AMERICANS AT RISK UNTIL CONGRESS PASSES TERRORISM INSURANCE PROTECTION"
FEBRUARY 27, 2002

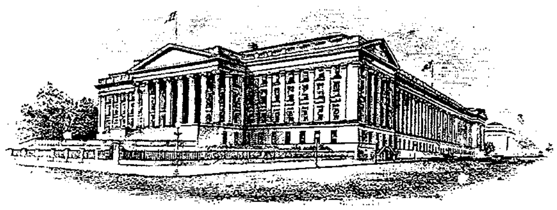
Chairwoman Kelly, members of the subcommittee and distinguished guests, I am pleased that we are holding this important hearing today to discuss an issue that is very much present in people's minds since September 11. I am sure that all of us in this room let out a collective sigh of relief and joy when the Winter Olympic Games concluded without incident. As our nation continues to recover from the events of September 11, I remain confident that the insurance market will also recover from the terrorist attacks. Nevertheless and not surprisingly, we all have different views as to how long this recovery is expected to take and how exactly it will happen.

Only last October we heard testimony to the effect that there was great uncertainty as to what would actually happen if Congress did not act to provide back-up for terror coverage. At the time, there was widespread believe that either the industry would experience a devastating setback or that the potential consequences would at least be severe enough that Congress "should worry." Well, Congress does worry. However, I also understand that the terrorist attacks may have just only begun to affect the market mechanisms to provide terrorism insurance.

While it's reassuring to know that the worst-case scenario did not play out, many answers are still missing. For instance, how much longer before the market corrects itself and the current cycle changes? What is the cost for this potentially long-process? Has the fact that Congress has not yet provided backup legislation been detrimental as it was feared in the fall of 2001? These are all valid questions that warrant immediate and honest answers. Your acceptance to appear before this subcommittee today brings us a step closer in obtaining these answers and expediting a solution to the current problems.

I would like to thank our guests for joining us today and I look forward to hearing their testimonies.

Thank you Chairwoman.



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 3:00 P.M. EST
February 27, 2002

CONTACT: BETSY HOLAHAN
202-622-2960

Economic Impact of the Lack of Terrorism Risk Insurance

Testimony of Mark J. Warshawsky,
Deputy Assistant Secretary for Economic Policy, U.S. Treasury
Before the Financial Services Subcommittee on Oversight and Investigation
United States House of Representatives

Wednesday, February 27, 2002

Chairwoman Kelly, Representative Gutierrez, Members of the Subcommittee, I appreciate the opportunity to present to you the views of the Office of Economic Policy at the Treasury Department on the current and possible future impacts of the lack of terrorism risk insurance on the American economy. We appreciate the speedy action of the House in passing legislation last year that would have created a temporary federal back-stop to insured losses from terrorist attacks. We look forward to continuing to work with you to achieve our shared objective of restoring private insurance coverage for this risk. Terrorist attacks have the potential for significant nationwide costs and thus justify a carefully designed collective approach to insuring against the losses from such events, utilizing the already existing coverage and payment mechanisms of private insurance markets.

The terrorist attacks have had a negative impact on the ability of businesses and property owners to insure against risk.

Industry estimates of insured losses resulting from the attacks of September 11, over all principal lines of coverage, range from $30 billion to $90 billion, with the consensus estimates in the $36 billion to $54 billion range. These losses hit many major lines of the property/casualty insurance business including property, business interruption, workers' compensation, and liability, as well as life and health. Wherever the final figures settle, these will be the largest insured losses in history. By contrast, Hurricane Andrew, which led to significantly higher premiums and reduced availability of insurance in flood prone areas, caused, in today's dollars, $19.3 billion of insured losses in all lines, although it should be noted that the industry was much better capitalized on the eve of the September 11th tragedy than it was when Andrew hit.

Investment losses experienced by primary property/casualty (P/C) insurance and reinsurance companies, which had been growing prior to September 11, accelerated dramatically immediately after that date. Hence, unlike other insured events, the insurance losses from these terrorist attacks were highly correlated with investment losses at the time -- a difficult and risky situation for insurance and reinsurance companies.

In addition to these two types of losses actually experienced, the attacks revealed to the insurance industry a potential for huge future losses which it had not priced before and cannot yet readily model. Terrorism creates the possibility of a large loss, but it does so with an uncertain probability. This is unlike other insurable events where the law of large numbers operates to effectively pool risk, as in personal lines such as life, health, long-term care or automobile. It is more comparable to dramatic natural catastrophes, such as hurricanes or earthquakes, causing large losses. But unlike terrorism risk, natural catastrophes have predictable patterns and probabilities quantifiable by sophisticated models, based on past weather conditions or seismic activity, that better allow the assumption and diversification of risk.

It is well known that primary insurers in most lines of coverage reduce their risk by laying it off to reinsurers. Reinsurance is a valuable, sensible, and well-established way of spreading risk. Many participants in the reinsurance market are large sophisticated organizations, are often foreign-owned and operate world wide, thus assuring that risks in any one country or type of business are spread around the world. As a consequence of the September 11 losses, which reduced their capital base, and the inability to model terrorism risk, at least at the present time, the reinsurance industry has almost entirely stopped assuming terrorism risk. Primary insurers have also withdrawn, and continue to withdraw, from covering this risk in states and lines of coverage where the law or insurance regulators have not prevented them from so doing.

I will be brief in summarizing the insurance market impacts; I understand that the testimony of the GAO will cover this in detail.

Primary insurers are being allowed by insurance commissioners in all states, with the prominent exceptions of New York, California, and Georgia, to exclude terrorism coverage above certain dollar amounts from smaller, regulated commercial policies. Most states, however, do not allow an exclusion from damage caused by fire following a terrorist attack. No states have allowed the exclusion of terrorism risk in personal insurance lines.

Terrorism is defined broadly in the exclusion as activity that involves the threat of, or actual use of, violence if the effect is to intimidate the government or disrupt some segment of the economy and the intent is to further political or ideological objectives. The definition includes the use of nuclear, chemical or biological weapons. It apparently does not make a distinction between the foreign or domestic origin of the act of terrorism.

Because state laws do not allow companies offering workers' compensation insurance to exclude terrorism risk, some primary insurers have chosen to drop the workers' compensation line completely, rather than underwrite terrorism risk absent reinsurance. Others are issuing it on a more selective basis, forcing many businesses into state sponsored insurance pools. In one case brought to our attention workers compensation insurance was not renewed because the insured had over 500 employees located in a tall office building in Pennsylvania.

Insurance brokers report that terrorism coverage for large commercial properties, whose insurance policies are unregulated, is difficult to obtain, and importantly, subject to limits of coverage that are much lower than customers want. And premiums for these properties have increased dramatically. In some instances the total policy cost with limited terrorism coverage is reported to be roughly double the cost of the P/C policy without the terrorism coverage. Stand alone coverage for terrorism risk is very limited and quite expensive where it is available. In fact, separate terrorism risk coverage costs more than the insurance covering all other risks while it provides a lower limit and responds to only one event.

Owners of large commercial properties and holders of mortgages on such properties (pension funds, trusts, etc.) are reluctant to discuss the extent and nature of their insurance coverage because few property owners want to make public the fact that they are uncovered or inadequately covered. This makes it especially difficult to gage the extent of the coverage and cost problems, but we have indications that they are widespread on many types of properties, especially those currently thought to be most at risk from terror attacks.

The effects of conditions in the market for terrorism risk insurance are being heightened by rising rates for types of insurance coverage unrelated to terrorism risks, where the insurance market is tightening. Insurance brokers, who deal in most commercial P/C coverage, report that median rate increases are 30-50 percent and mean rate increases are 40-70 percent. Industry sources report that rates had begun to rise and coverage shrink well before September 11 as part of the classic underwriting cycle. This cycle is generally started when insurance company earnings on investments decrease, reducing their capacity to underwrite insurance. Insurance industry capital losses as a result of September 11, however, have exacerbated the cycle, as has the increased risk for primary insurers remaining after excluding allowable terrorism risk coverage. While some increase in premiums might be expected in response to the low earnings in the insurance industry before September 11 and the attacks themselves, the recent increases have been so dramatic that they harm the Nation's economic recovery.

These insurance difficulties in turn are affecting the financing of new real estate projects and sales of existing properties.

Reports to us indicate that financing is limited for new construction and/or acquisition of high-profile properties which are at risk for terrorist attack and inadequately insured. Lenders are carefully screening the location and size of buildings. Some are simply refusing to lend on trophy properties that are not fully insured. Others will lend on underinsured properties, but only if the owner will provide recourse. In one case, a large construction project in the Midwest known to be financially viable prior to September 11 is now at risk of being abandoned because of gaps in the available terrorism coverage. Eventually the market might be able to price for the new risks facing such properties. Both the severity and timing of changes to date, however, make them harmful to the economy.

The impact on existing properties at risk is equally troubling. While, technically, properties without adequate insurance are in default of financing covenants, lenders may well not foreclose but, rather, raise their fees to cover their own risk. Rating agencies have indicated that they will substantially increase subordination levels on new issues of commercial mortgage backed securities whose collateral properties have inadequate insurance coverage. They are also in the process of establishing risk criteria that would lead to the downgrading of securities collateralized by properties inadequately insured and at an elevated risk of attack. Those deemed high risk by the agencies include trophy assets, symbols of America, structures for large gatherings of people (arenas, stadiums, and convention centers), critical infrastructure (major bridges, tunnels, and transportation hubs), and critical energy-providing structures. It also includes structures that are tall, located in a central business district, or with a highly visible tenancy.

Ratings downgrades would, of course, have a major negative impact on the value of such securities, which are widely held by mutual funds and pension plans. Spreads between the yields for large property commercial mortgage backed securities and Treasury securities have in fact widened recently, especially for properties with greater exposure to terrorism risk. And we have received reports that the volume of commercial mortgage backed securities issued since the beginning of the year has fallen.

We have particular concern about the impact of high premium rates and lack of insurance availability for smaller projects being built near what is considered potential terrorist targets. Hospitals, municipal entities and other nonprofits where trustees feel a fiduciary responsibility may well forgo terrorism coverage if they see the cost is equal or greater than what they're paying for all other perils.

Of equal concern to us is the steep rise in rates for commercial and other insurance policies for all developers, because this rise has the potential to cause significant impact on the economy and is likely to last for the next year or two. While low interest rates may be offsetting some of the increased insurance costs right now, we cannot count on that situation to remain constant.

Finally, the full effects of the terrorist attacks on insurance conditions have yet to be felt, because about a third of the reinsurance treaties and many primary insurance contracts negotiated prior to September 11 have not yet expired. Many real estate lenders are still deciding how to adjust their lending strategies to the lack of coverage for their properties. Others may delay bringing properties to markets in hopes of improvement later. These impacts are difficult to quantify and document because they are dispersed, and the affected policyholders may be reluctant to publicize that they are having trouble finding financing for real estate projects, or that outstanding debt secured by inadequately insured property risks a ratings downgrade. In this regard, I understand that the SEC is considering whether to require businesses left without commercial terrorism risk insurance after the September 11 attacks to disclose the loss to investors as a material risk factor.

The implication of these insurance market conditions and economic consequences makes it critical for Congress to enact a federal terrorism risk insurance backstop for at least four reasons.

1. The lack of coverage and high premium rates imply a drag upon our economy and a burden to the nascent recovery, including the potential for a loss of even more jobs. Some are now arguing that the lack of a dramatic economic impact resulting from Congress' failure to enact a federal terrorism risk insurance backstop prior to January 1 means that the legislation is not necessary. This argument reflects a fundamental misunderstanding of the nature of the problem and the drag that terrorism risk is placing on an economy that is in the early stages of recovery. As I've indicated, the insurance industry has been significantly destabilized, with coverage well below "equilibrium", and prices for coverage well above normal levels. Investors in new properties and lenders on properties on which contracts have expired are paying disequilibrium costs, either directly, because of the spikes in renewal policy costs, or indirectly, because they are the ones now bearing this risk.

The economic impact is therefore two-fold: first, the decreased returns and higher risk experienced by businesses and developers are a disincentive to future investment over this interim period. Second, as suppliers of capital in turn seek to lay off the cost, the impact is passed through to consumers and workers. Further, it will increase as more and more insurance contracts come up for renewal. In brief, the impact is just like a "tax" increase on productive capital. What is the ultimate impact on consumer prices and jobs? While it is always difficult to estimate accurately, we know that in the long run, in our open and elastic capital markets, workers and consumers will bear the brunt of the burden.

2. The cost of lost and postponed investment opportunity is potentially large for future economic growth. Many real estate lenders are still deciding how to adjust their lending strategies to the lack of coverage for their properties. Many developers may be delaying bringing properties to capital markets in hopes of improvement in insurance conditions later, which in turn is now dependent on government action. Thus capital is not committed to worthy projects--that would have received financing and created jobs had insurance markets been in a better equilibrium.

3. Inaction paralyzes the private sector. Furthermore, the lack of government action, one way or another, is itself costly as insurers, financiers, and businesses wait to see what new institutions the government might set up before themselves committing to creating new insurance mechanisms, even ones significantly less efficient than a robust private insurance market. Moreover, economic activity itself could adjust in the design and location of building projects. Planning and decision making would be much better if they knew the insurance environment they faced. We can do better by our investors, consumers, and workers than this.

4. The economic impact of another terror attack could be even greater than the September 11 attack. Finally, there is a real concern about the potential costs to the federal government and the economy in the event of another attack, with no backstop program in place to stem the tide of uninsured and underinsured properties. Private insurance covered a significant percentage of losses arising from the September 11 attacks. Following the attacks, insurance companies quickly stated that they would pay claims on the World Trade Center and other losses (including business interruption) incurred because of its destruction. The ability of the insurance industry to make this simple and credible promise was likely instrumental in calming investors after the attacks and giving business confidence that funds would be available to resume business operations, particularly in New York City.

The subsequent rapid disbursement of payments has been vital in speeding New York City's recovery according to a report commissioned by that city's Chamber of Commerce. Nearly half of the projected payouts are expected to be made within a year of the attack. Such rapid disbursement will be possible only because a payment scheme (via well-established insurance conduits) was in place prior to the attacks. Trying to devise such a scheme on short notice and in the aftermath of another terror attack would be considerably less effective and would slow recovery.

But without a backstop program in place to encourage participation by private insurance that might well happen. In the event of a major terrorist strike, many of the losses would likely be borne by the federal government. We would expect defaults on commercial mortgages and other losses. It might be difficult to resist the call for federal assistance to compensate uninsured property owners and businesses victimized by the terrorist strike. Compensation for losses by private insurance industry has worked smoothly and efficiently. It is highly unlikely that a federal payment system, hastily conceived in the aftermath of a major attack, could perform as well.

We need action now

As the President has stated strongly, our enemies are persistent, clever, and should not be underestimated: future incidents may be quite different from the attacks we have already experienced. Our enemies have stated that their intent is to cause economic harm, as well as physical harm, to us. We firmly believe that our Nation's battle against the scourge of terrorism will ultimately be successful. We also believe that private markets will stabilize--capital levels will be restored and insurers' ability to price this risk will improve. But we now know how difficult and costly it can be for an economy to adjust to terrorist events. We bear responsibility for assuring that our citizens are adequately protected against terrorism. This includes our citizenry's ability to obtain insurance in the interim against this insidious threat, as well as reducing the costs of restoring their financial well-being were another event to occur. And we want to encourage economic growth. Hence, we have proposed a federal insurance backup.

Congress should act before the economic damage caused by lack of terrorism risk insurance takes too great a toll. We want to work with you to create the best possible support for our economy, job creation, and consumers.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives

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TERRORISM INSURANCE

Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities

Statement of Richard J. Hillman
Director, Financial Markets and Community Investment

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Accountability * Integrity * Reliability

GAO-02-472T

Madam Chairman and Members of the Subcommittee:

The tragic events of September 11, 2001 brought to light the huge potential exposures insurance companies could face in the event of another terrorist attack. Faced with continued uncertainties about the frequency and magnitude of future attacks, at the same time government and military leaders are warning of new attacks to come, both insurers and reinsurers have determined that terrorism is not an insurable risk at this time. As a result, in the closing months of last year insurers began announcing that they could not afford to continue providing coverage for potential terrorism losses. The effects of this trend have yet to be fully realized, but there is some indication that it has begun to cause difficulties for some firms in certain economic sectors.

Considerable debate has taken place on what the federal government can do to keep commercial insurance companies involved in providing terrorism insurance, even without the protection that they normally receive from reinsurance. While this Committee and the House of Representatives did pass H.R. 3210, the Congress as a whole did not adopt legislation.

Today, two months into a new year, uncertainty and concerns continue, both in the insurance industry and the economy, over the issue of terrorism insurance. As you requested, my testimony today will describe how, in the absence of federal action, insurance companies and the marketplace have reacted to the events of September 11th. I will also present GAO's initial observations on the potential consequences these market changes may have, both in the event of another terrorist attack and, as we all hope, in the absence of one. Finally, I have included a discussion of the language developed by the Insurance Services Office (ISO) and adopted by most states to exclude terrorism from commercial property and casualty (P/C) coverage (appendix 1).

My statement today is based on discussions with a variety of insurance industry participants, regulators, policyholders, and other affected parties. Because many companies were deeply concerned about the possibility that their difficulties in getting terrorism coverage might become general knowledge, they spoke to us only on condition of anonymity. Finally, my statement primarily addresses the availability of terrorism insurance coverage. Despite rising prices in the remainder of the commercial P/C market, insurance coverage is still available, though at prices above those in effect prior to September 11, 2001.[1]

In summary, because insurance companies believe that neither the frequency nor the magnitude of future terrorist losses can be estimated, they are withdrawing themselves from the market. Insurance for losses from terrorism is disappearing, particularly for large businesses and those perceived to be at some risk. This withdrawal is happening fastest among reinsurers. Direct commercial P/C insurers' withdrawal has been slower and less complete because of regulatory constraints and legal requirements in some states that preclude insurers from excluding terrorism from coverage for workers' compensation and for fire (irrespective of its cause).

Because the insurers' withdrawal has been gradual, the extent of the potential economic consequences is still unclear. What is clear is that in the absence of terrorism insurance, another terrorist attack would dramatically increase direct losses to businesses, employees, lenders, and other noninsurance entities beyond those resulting from September 11th. Furthermore, should the government decide to intervene after a future attack, it would do so without readily available claims-processing and payment mechanisms that exist in the insurance industry.

Even in the absence of an actual terrorist event, however, there are growing indications that some sectors of the economy—notably real estate and commercial lending—are beginning to experience difficulties because some properties and businesses are unable to find sufficient terrorism coverage, at any price. If allowed to go unchecked, these difficulties are likely to increase as more insurance contracts come up for renewal over the next year. The resulting economic drag could slow economic recovery and growth.

[1] Prices were already increasing for commercial coverage prior to September 11th. Industry participants have told us that the increases were a part of the underwriting cycle normal in this insurance market. Industry losses from the terrorist attack almost certainly exacerbated the rise in prices, as any major catastrophe would have. While there may be some examples of excessive price increases in the market, as long as insurance continues to be available, it is likely that competitive pressures will ultimately remedy that problem.

Insurers Are Shifting Terrorism Risk to Property Owners and Businesses

Since the September 11th attacks, the key dynamic taking place in the insurance industry has been a shifting of the risk for terrorism-related losses from reinsurers to primary insurers and then to the insured. Reinsurers and insurers have begun shedding their exposure to terrorism risk as insurance contracts come up for renewal, leaving policyholders increasingly exposed to losses from a terrorist attack. Prior to September 11, 2001, insured losses resulting from terrorism in this country were extremely infrequent. Insurance companies considered the risk so low that they did not identify or price potential losses from terrorist activity separately from the general property and liability coverage provided to businesses. But after the September 11th attacks, insurance companies recognized that their risk exposure was both real and potentially enormous. As a result, they began to express concern about continuing to include terrorism coverage as an unpriced component of commercial P/C insurance contracts. Insurers pointed out that experience with major terrorist events has been so limited, and the potential losses so large, that setting an actuarially sound price for such coverage is virtually impossible. Many insurers now consider terrorism an uninsurable risk, at least for the moment. Their response to any risk they consider uninsurable, as many Californians living on fault lines have found, is not to offer insurance. This trend has become evident in the case of terrorism insurance.

Reinsurers Are Withdrawing from the Market for Terrorism Insurance

Reinsurers—companies that routinely take on some of the risk that direct primary insurers face in return for a share of the premiums—are now unwilling to participate in terrorism coverage because of the enormous losses they suffered after September 11th and the newly recognized difficulties of pricing terrorism insurance. Reinsurance is a vitally important element of the insurance industry's capacity to provide coverage to policyholders. As a mechanism for spreading the risks taken by insurance companies, reinsurance allows primary insurers to accept large risks and, by reinsuring a portion of those risks, to protect themselves from a potentially catastrophic loss. Like syndications of large loans by groups of lenders, reinsurance provides a way to insure large risks without exposing a single insurer to the possibility that its entire capital base would be wiped out because of a single event. Reinsurance companies also provide a channel through which investors can introduce capital to insurance markets without having to develop the extensive distribution channels required by direct primary insurers.

However, because reinsurance markets are global in scope and because reinsurance transactions are considered to be contracts between sophisticated parties, neither the prices nor the conditions of such coverage are subject to direct regulation. As a result, after September 11th, reinsurers had little difficulty excluding terrorism from coverage. Generally, these exclusions become effective on the policy renewal date. As stated by witnesses before this Subcommittee in October, a large share of those contracts expired at the beginning of January.[2] Industry sources confirm that little reinsurance is being written today that includes coverage for terrorism. There are exceptions. Low and medium risks, particularly in industries or geographic locations where there is little perceived exposure to a terrorist event, are the least affected. However, large companies, businesses of any size perceived to be in or near a target location, or those with some concentration of personnel or facilities are unlikely to be able to obtain a meaningful level of terrorism coverage at an economically viable price. Where coverage is available, it tends to have high deductibles and tight limits on the level of coverage. In general, reinsurers are being very selective on the exposures they will accept, if any. The higher the risk, the less likely it is that reinsurance coverage will be available. And even in those limited cases in which some reinsurance coverage for terrorism is still available, the prices are very high.

As Primary Insurers' Exposure Increases, They Also Are Excluding Terrorism Coverage

As reinsurers walk away from terrorism insurance, primary insurers' exposure increases, at least in the short run. However, while reinsurance contract renewals tend to be concentrated at the beginning of January and July, primary insurance contracts tend to renew at a relatively even rate over the year. As a result, industry observers and participants have told us that primary insurers' exposures have increased dramatically and will not fall unless and until they can, in turn, exclude terrorism from their coverage.

Faced with this kind of exposure and a risk they do not believe can be priced, industry observers and participates mentioned that primary insurers will need to emulate their reinsurance counterparts and exclude terrorism coverage from some commercial insurance policies. However, a number of factors are affecting both the speed and the extent to which primary insurers can insulate themselves from terrorism. First, in contrast to reinsurance, changes to the coverage provided[3] by direct insurers

[2] Whether 70 percent of all reinsurance policies did in fact expire at that time, as was suggested, is difficult to determine. However, the consensus of industry sources is that the majority of reinsurance contracts did expire then and that reinsurance contract renewal cycles tend to be concentrated at the beginning of January and the beginning of July.

[3] Called "policy form" by state regulators.

require regulatory approval in most states, at least for low- and medium-risk companies.[4] This regulatory hurdle caused ISO, acting on behalf of P/C insurers, to file a request in every state for permission to exclude terrorism from all commercial insurance coverage.[5] As of February 22, 2002, 45 states and the District of Columbia and Puerto Rico had approved the ISO exclusion, according to information received by ISO and the National Association of Insurance Commissioners (NAIC). The other five states either denied the suggested language from ISO or are still considering the language for approval or disapproval.[6] States that have not approved the ISO exclusion expressed concerns about various issues. Among them are the low thresholds for exclusion ($25 million or 50 serious casualties); the all-or-nothing nature of the threshold (insurers pay nothing if either threshold is reached); the aggregation of all losses from multiple incidents within a 72-hour period and across most of North America into one event if they "appear to be carried out in concert or to have a related purpose or common leadership"; fear that the exclusion would leave some small and medium-sized businesses that could least afford the losses from a terrorist attack totally unprotected; and worry that the included definition of terrorism is overly broad. Nevertheless, because of regulatory concerns about the solvency of primary insurers who cannot get reinsurance, ISO's exclusion language has been approved in 45 states and the District of Columbia and Puerto Rico. Primary insurers in those states can now exclude terrorism from coverage on various lines of commercial policies. While only five states have not (yet) accepted the ISO exclusion language, those five states account for more than 35 percent of the total U.S. commercial insurance market.[7]

[4] Many states do not require regulatory approval for "large" risks. The resulting contracts are sometimes called "manuscript" or "script" policies and are considered to be contracts between sophisticated parties.

[5] The blanket approval does not compel insurers to exclude terrorism from every contract, but it assures them of regulatory approval when they choose to exclude such losses.

[6] A description of the ISO terrorism exclusion can be found in appendix 1.

[7] There is no reliable information, however, on the share of the commercial P/C insurance market in those states that is actually affected by the rejection of the exclusion. Each of these states already exempts "large, sophisticated buyers" from the regulations governing the terms of insurance contracts. These buyers could, and many may already have, renewed insurance contracts without terrorism coverage.

Second, even though direct insurers now have regulatory approval to exclude terrorism from commercial P/C insurance contracts in most states, such a change in coverage generally would have to wait until the renewal date. According to some insurance regulators with whom we spoke, losing reinsurance would not generally be a sufficient reason for canceling or changing coverage for policyholders during the policy period. Moreover, even when an insurance policy terminates, insurers generally have to give 30 to 60 days advance notice to policyholders before non-renewing a policy or making a significant change in coverage. As a result, it could be as much as a year after a direct insurer loses reinsurance coverage for terrorism before a similar exclusion could be passed on to all its policyholders.

Finally, even at renewal, laws existing in some or most states will affect the extent to which insurers can completely end their exposure to losses resulting from terrorist events. For example, laws in nearly all states preclude a workers' compensation insurer from excluding coverage for a particular type of event. Workers' compensation must cover all the risks to which an employee is exposed while at work, irrespective of the cause. Industry sources estimate that approximately 10 percent of the losses resulting from the World Trade Center attack will be due to payments for workers' compensation claims.

Similarly, insurance laws in approximately 30 states include what is called "standard fire policy" language, according to ISO officials. In that language, insurers are required to pay losses resulting from fire, irrespective of the cause. Thus, in an explosion like the World Trade Center attack, a terrorism exclusion would protect insurers from liability for losses resulting from the direct effects of the explosion, but not for the losses caused by the resulting fire. Estimates suggest that the fire, rather than the explosion itself, caused a substantial portion of the losses in the World Trade Center attacks. Industry sources have said that they expect an effort to change this requirement. In all of the states where the standard is written into state statutes, an act of the state legislature would be required to modify it.

Thus, even though many reinsurers can and have moved quickly to exclude terrorism from reinsurance coverage, primary insurers' ability to exclude terrorism is more limited, at least in the short run. However, the rapid submission of the ISO exclusion language to state insurance regulators, and their generally rapid and positive response, clearly indicate the urgency of primary insurers' desire to be able to exclude terrorism from commercial P/C insurance coverage. Early indications suggest that many businesses, particularly those in large metropolitan areas, are already beginning to experience difficulty obtaining terrorism coverage as their insurance policies come to renewal. In our discussions with insurance industry participants, observers, and policyholders, we found that large commercial enterprises were among the first to feel the impact of terrorism exclusions. Some large property owners or developers reported that they are having to underinsure or "go bare" by self-insuring for terrorist risks because of the lack of available coverage or very limited coverage for the quoted prices.

As Business Exposure to Uninsured Risks Rises, so Do the Potential Economic Consequences

While the extent of the negative economic impacts of a lack of terrorism coverage is not yet clear, the potential for more severe economic impacts is increasing as the level of uninsured risk climbs. Over the next year, the level of uninsured risk for terrorism-related incidents is expected to continue to rise as commercial policies renew between primary insurers and policyholders and insurers seek to exclude terrorism-related coverage from policies they cannot reinsure. Therefore, the economic burden of another terrorist attack would fall increasingly on policyholders as the insurance industry sheds or limits its risks to such exposures, raising the potential for more devastating economic consequences should such an event occur.[8] Additionally, as insurers exit the market for terrorism-related coverage, so too does their claims-processing capacity for administering recovery assistance to victims of a terrorist event.

Even in the absence of another terrorist event, adverse impacts due to the lack of adequate terrorism coverage appear to be surfacing, although their ultimate impact on the economy as a whole cannot yet be gauged. Additional cases of adverse economic impacts to individual firms caused by the absence or high price of coverage for terrorism-related events are likely to become more evident as policies continue to be renewed over the next year.

[8] Of course, direct insurers are still bearing some of the risk and may not be able to shift all the risk to policyholders in the near term. If an event were to occur soon, this exposure could result in insolvency and failure for some otherwise healthy insurance companies, potentially affecting the availability of other kinds of insurance.

Another Terrorist Attack Could Have More Severe Economic Consequences

Many of the most severe potential negative consequences resulting from the lack of terrorism insurance coverage will only become evident if another terrorist attack occurs. The shifting of risk from reinsurers to primary insurers to commercial policyholders and other affected parties could place more risk and economic burden on businesses and the public at large should another terrorist attack similar to September 11th occur.[9] Consequently, a lack of such coverage in the event of another attack could have much broader effects on the economy.

Recent estimates of the losses paid by insurers as a result of the attacks on the World Trade Center are about $50 billion, of which reinsurers are expected to ultimately pay about two-thirds. If another terrorist event of similar magnitude were to take place, all those losses would still be incurred. However, depending on the timing of the event, the effect would be very different, because even today the reinsurers would be responsible for a much smaller share of the losses. As the event moves farther into the future and primary insurers successfully exclude terrorism from insurance coverage, the losses will increasingly be left to the affected businesses and their employees, lenders, suppliers, and customers. Because these entities lack the ability to spread such risks among themselves the way insurers do, another terrorist attack similar to that experienced on September 11th could have significant economic effects on the marketplace and the public at large. These effects could include bankruptcies, layoffs, and loan defaults.

Another significant consequence of the insurers' exiting the market for terrorism coverage is the absence of a claims-processing mechanism that can effectively and efficiently respond to victims of an attack. After September 11th, insurance companies, working with public risk-management groups, are reported to have mobilized extensive resources to pay many claims quickly. The administrator of the special government program to compensate victims in the aftermath of the September 11th attacks has noted the challenges of creating a mechanism for identifying victims and properly disbursing aid, even several months after the attacks. If, without insurers, the government should emerge as a principal source of financial recovery after another attack, it would first have to create the

[9] In this statement, we assume that another terrorist event would be property-damage intensive, similar to the World Trade Center attacks. Of course, a successful terrorist attack, such as a biochemical or nuclear incident, would pose significantly different challenges to the insurance industry and the economy, although the ISO language contains a total exclusion for nuclear, biological, or chemical attacks.

infrastructure to process claims and disburse financial assistance to victims, duplicating the mechanism already in place in the insurance industry. Therefore, the potential economic impacts of another incident on the scale of a September 11th attack could become even more devastating absent insurance mechanisms to quickly help businesses recover and restore economic activity. The current movement by insurers to insulate themselves from terrorism-related losses, however, means that their involvement in the recovery process after another terrorist event would also likely be substantially lessened.

Some Examples of Adverse Impacts Are Surfacing Due to the Lack of Adequate Terrorism Coverage

Even if no other terrorist attacks occur, some adverse conditions are beginning to appear in the marketplace due to the lack of adequate terrorism coverage, though the impacts on the economy as a whole are still unclear. As noted earlier, commercial property owners and businesses are now facing higher P/C rates coupled with substantially reduced protection for terrorism-related risks as P/C policies renew over the coming year. Insurance industry observers and policyholders report that while limited coverage for terrorism-related losses is currently available at very high rates, full coverage is often not available at any price, forcing larger commercial policyholders to operate with little or no coverage for such risks. Cases of adverse economic impacts to individual firms caused by the absence or high price of coverage for terrorism-related events are likely to become more evident as policies continue to be renewed over the next year.

Some examples of large projects canceling or experiencing delays have surfaced, with the lack of terrorism coverage being cited as a principal contributing factor. Overall, it is still unclear to what extent financing arrangements for existing or planned projects will be jeopardized as lenders and investors are faced with the prospect of absorbing additional terrorism-related risks that cannot be insured. These financing arrangements encompass both development and resale markets, where financing is contingent upon full insurance coverage for collateral assets backing the loan or investment. Some industry observers believe private markets will eventually develop and expand the capital available for terrorism insurance coverage, but whether or how quickly an adequate market can materialize is not yet evident.

Our contacts with various industry and regulatory sources indicate that some financial problems are surfacing due to the lack of terrorism coverage, though it is still too early to gauge how widespread these problems will become. Though we could not independently validate each of the assertions provided, we found consistency among the sources in the reasons contributing to delays or cancellation of projects. These reasons can be attributed to uncertainty and an unwillingness among lenders and investors to accept risks that cannot yet be reasonably estimated and that insurance companies are unable to price.

Property Owners and Developers

Two of the most common adverse impacts being cited by commercial sources, particularly owners and developers, are the conditions of having to go bare or only partially insure assets against terrorism due to the inability to obtain meaningful terrorism coverage. Even when limited coverage is available, uncertainties about the frequency and cost of future events cause insurers to set premiums very high. This condition appears to be particularly acute for properties located in central business districts of major metropolitan areas.

Specifically, several property owners that we spoke to with properties across the United States reported not being able to purchase the amount of terrorism coverage they need because the capacity they require is not available in the current market. As a result, these owners are largely bare for terrorism risks and liable for any uninsured damages that would result from a terrorist attack on their properties.

For instance, a major North American commercial real estate firm that owns trophy[10] properties and office buildings in the central business districts of several major U.S. cities reported that it cannot find enough terrorism insurance to cover the value of its properties. This firm previously had a blanket property insurance policy providing $1 billion of total coverage—including terrorism—that expired in October of 2001. Since that time, the firm has been able to find only one insurer who would offer it a quote for stand-alone terrorism insurance for a maximum $25 million of coverage. The firm stated that minimal damage to its buildings could surpass $25 million in claims and that this limit was inadequate.

In another example, a New York insurance brokerage firm reported that it tried to obtain terrorism coverage for a client's portfolio of non-trophy office buildings in New York City. The incumbent insurer agreed to provide $100 million of insurance coverage on the portfolio that included

[10] For purposes of this report, "trophy" properties are those properties that are sometimes regarded as icons of American business, culture or history, or that could be considered as representative of American culture or values. Because of their symbolic status, insurers consider them to be at high risk for a terrorist attack.

terrorism, at double the cost of the previous year's $500 million policy. The broker could not find more terrorism coverage for these properties. Industry consultants also reported that their clients were experiencing difficulty finding sufficient liability insurance for terrorism risk.

An owner and operator of a midwestern city's principal airport and several smaller area airports reportedly experienced a 280 percent increase in its aviation liability premium for 2002. The new policy does not include war risk. The insurer offered $50 million in war risk and terrorism coverage back to the airport owner in a stand-alone policy for a premium of $1 million. The owner needs $500 million in coverage to satisfy its obligation to customers.

Lenders and Borrowers

Property owners' search for terrorism coverage has been driven not only by the fear of personal liability for terrorist attacks to their properties, but also by the fact that lenders are requiring this coverage on the collateral backing existing mortgage loans. Therefore, the shifting of risk back to the policyholders is also creating adverse business conditions for lenders and investors. Lenders typically require borrowers to carry all-risk insurance coverage to protect the value of loan collateral.

Lenders and investors are now voicing their concern over their increasing exposure to terrorism-related risks as collateral assets on mortgages become uninsured for such risks. Post-September 11th, many lenders began notifying borrowers with properties considered at risk for terrorism of the requirement to carry insurance for the risk of terrorism. If borrowers cannot obtain the requisite terrorism coverage, lenders may find them in violation of their loan covenants. Lenders and investors are now being faced with the dilemma of either allowing their risk exposure to increase or acting to terminate existing loan agreements because terrorism coverage is not available to satisfy insurance requirements on the agreement. Overall, it is not yet clear how financial institutions will react to borrowers that cannot satisfy insurance requirements on existing loans.

In one case, a firm that develops large-scale buildings and that owns over a hundred non-trophy office and residential buildings both in the suburbs and central business districts of cities in several East Coast states reported that it cannot find enough terrorism coverage to cover the replacement value of its holdings and satisfy the lenders' insurance requirements. The firm currently has mortgage loans on each of its properties with over 30 different lenders ranging from local savings banks to investment banks, pension funds, and the securities market. All of the firms' lenders notified the firm that insurance policies on the properties must include the risk of terrorism. As the firm's current umbrella policy expires in March 2002, the firm began looking for the requisite insurance coverage to maintain compliance with the lenders' terms. For fiscal year 2001–2002, the firm had purchased a blanket property insurance policy covering $300 million per property per occurrence for a premium of $1 million. The firm reported that the same amount of coverage was available for 2002–2003 for $5 million, but it excluded terrorism. The firm found only one insurer who would offer a quote for a stand-alone terrorism insurance policy. This quote specified a maximum coverage of $75 million for a premium of 1.5 percent, or $1,125,000. As $75 million is not enough to cover the replacement value of any of the buildings it owns, the firm stated that it would be in technical default of its loan covenants when its current insurance policy expired.

In another case, the owners of a major midwestern mall reported that when their all-risk insurance policy on the property expired at the end of 2001, they purchased a terrorism-excluded insurance policy because they could not find one that would cover the risk of terrorism. The mall's mortgage lender objected to the policy's terrorism exclusion and argued that it violated the "all-risk" insurance requirement stipulated in the loan documents. Consequently, the lender notified the owners that it had purchased a stand–alone $100 million terrorism insurance policy to protect the mall from this risk. Furthermore, the lender demanded repayment by the mall of the $750,000 premium. The mall owners protested the lender's action, arguing that they could not be required to purchase insurance that was not available to them or other owners of similar properties. The owners successfully sought a temporary restraining order from the courts to prevent the lender from forcing repayment of the insurance premium.

Similarly, another lender described the adverse business relationships created as the bank responded to the technical default of mortgages when full terrorism insurance was not in force. From the bank's perspective, it is being asked to absorb risk that it had not previously priced into the mortgages and is therefore putting pressure on its mortgage holders to obtain terrorism coverage. At the same time, the bank recognizes that the unavailability or increased cost of terrorism coverage will also negatively impact the mortgage holder's ability to service the loans. Consequently, the bank's likely course of action will be to review each loan on a case-by-case basis.

New Lending and Investment Activities

While owners with existing mortgages are not sure what actions lenders will take if sufficient terrorism coverage is not available, firms interested in buying and selling properties reported that the lack of adequate terrorism coverage has delayed or prevented certain projects. Several developers, financiers, and insurance industry observers noted a number of examples where lenders or investors were reluctant to commit resources to projects that could not be insured against terrorist acts. A common financing requirement places the responsibility on borrowers to fully insure the assets used as collateral in lending arrangements. In these instances, lenders and investors were unwilling to supply financing because the buyer or seller could not obtain adequate terrorism coverage on the property.

For instance, a general contracting firm in New York City reported that its bank will not provide financing for a proposed construction project unless it obtains all-risk insurance that includes terrorism coverage. The planned project is a 30-story apartment building in a high-risk area in New York City. The firm reported it has not been able to find an insurer that will sell it terrorism coverage at any price. Without this coverage, the firm cannot obtain the financing needed to hire construction workers and begin construction. The firm stated it typically hires 500 construction workers for projects such as this one.

Similarly, a firm stated that it could not obtain mortgage financing on an office building it owns on the East Coast because the firm could not purchase enough terrorism insurance to cover the replacement value of the property. Only one insurer offered a quote—for a premium of $800,000, at a level far below what the lender is requiring. Before September 11th, the insurance for this building, including terrorism coverage, was $60,000 for $80 million of coverage. The firm stated the mortgage lender refused to lend the money, despite the fact that the building had a guaranteed multimillion-dollar cash flow for the next 20 years. Without this loan and others like it, the firm's future growth potential is severely limited.

In another case, an insurance broker stated that a client who was interested in purchasing a major property found terrorism coverage available in the needed amount to satisfy the lender, but the coverage was too expensive to make the deal economically viable. This buyer needed $300 million in terrorism insurance to cover the replacement value of the asset and satisfy the lender' s insurance requirements. According to the broker, the buyer received a quote of $6 million for a $300 million stand-alone terrorism insurance policy. Although the buyer was able to find coverage, he was unable to purchase it, as the building in question generates only $75 million annually in rent. The buyer had budgeted $750,000 for all of the building's insurance needs. Given all the other expenses associated with the building's operation, maintenance, and loan service, the buyer believed that he could not afford terrorism insurance at that price. However, without that insurance, the buyer could not obtain financing for the deal and it was not completed.

Again, a mortgage broker reported that a client interested in the purchase of a trophy property in New York City could not obtain the $200 million necessary to finance its purchase. The broker stated that arrangements for financing with one lender were almost complete before the events of September 11th. After the terrorist attacks, the lender's credit committee reportedly decided it would not approve the loan unless the client could get enough terrorism coverage to cover the replacement value of the property. The prospective buyer could not find coverage or another bank that would lend the money without it.

In some cases investors have been unwilling to buy securities when the availability of terrorism coverage on assets backing the securities is uncertain. One example included a large insurance company with a loan of approximately $250 million on an office building in New York. An investment firm reported that this loan was scheduled for securitization as a way for the company to reduce exposure. Potential investors in the loan reportedly said they would not buy shares of the loan without terrorism coverage. The investment firm stated that since the insurance company cannot reduce its exposure in this type of loan, it is unlikely to provide capital for similar projects in the future unless terrorism coverage becomes available. In a second example, a capital management firm stated that it led the marketing effort for a domestic commercial mortgage-backed securities deal in the United States at the end of 2001. Investment firms in the United States and Europe chose not to purchase these securities primarily out of concern that terrorism insurance would not be available in the future.

The examples cited above do not allow definitive conclusions about the ultimate economic effects of the ongoing risk shift from reinsurers to insurers and on to property owners and businesses. However, they do indicate greater uncertainty, which may affect both financial decisions and real economic activity.

The Potential Negative Consequences of Not Having Terrorism Insurance Are Cause for Concern

Our government leaders continue to warn of imminent and credible terrorist threats. Should one of these threats become a reality in a world where insurers are no longer the first line of protection for businesses, the economic consequences could be very different from those following September 11th. As businesses both large and small are faced with uninsured losses that threaten their ability to survive, Congress could be faced with a time-critical decision to intervene or not. A decision not to act could have debilitating financial consequences for businesses, together with their employees, lenders, suppliers, and customers. At the same time, a decision by Congress to act could be difficult to implement quickly—and extremely expensive.

Even if, as we all fervently hope, another terrorist attack does not occur, there are indications that the lack of adequate terrorism insurance is beginning to affect firms in some sectors of the national economy. The ultimate scope of these effects is uncertain at this time, but they could become potentially significant in an economy recovering from a recession. Deciding whether Congress should act to help businesses obtain insurance against losses caused by terrorism is properly a matter of public policy. The consequences of continued inaction, however, may be real and are potentially large.

Madam Chairman, this concludes my statement. I would be happy to respond to any questions that you or other members of the Subcommittee may have.

Contacts and Acknowledgments

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Appendix I: Information on the Insurance Services Office (ISO) Exclusions for Terrorism and War Risk

The Insurance Services Office (ISO) develops standardized policy contract language - forms and endorsements - for use by property-casualty (P/C) insurers. Last October, ISO developed terrorism exclusion language and filed the language with each state's insurance department for use by its insurer-customers. ISO also offered the use of these endorsements for free to insurers that were not its clients. Insurers operating in states that have approved ISO's endorsements can choose to incorporate them into their insurance policies; insurers operating in states that have rejected or have not yet approved ISO's endorsements typically cannot.

Generally, ISO's endorsements describe, among other things, events that are considered "terrorism" and "war," define various thresholds that trigger the exclusion of insurance coverage, and describe events that would trigger the exclusion of all insurance coverage. For terrorism events, ISO wrote endorsements that could be used for different lines of insurance to explain when claims are not covered by an insurance policy. These endorsements contain essentially the same language. Concerning commercial property insurance lines, two endorsements were written – one for states that have statutory requirements for fire coverage and one for states without such a requirement. Another endorsement was written for commercial general liability policies.

As of February 22, 2002, forty-five states, the District of Columbia and Puerto Rico have adopted ISO's terrorism exclusions, while five states have either rejected the exclusions or are still evaluating them, according to NAIC officials. To gain further insight at the state regulatory level, GAO interviewed NAIC and several state regulators.

According to NAIC officials, ISO initially developed very broad exclusionary language and filed it with insurance regulators across the country. State insurance regulators raised concerns about the overly broad exclusionary language and recommended that ISO develop more consumer-friendly language that did not endanger insurer solvency. Late last year, when NAIC assessed that Congress would not be passing a federal solution, NAIC facilitated communications between ISO and state insurance regulators to narrow the impact of the exclusionary language. ISO has amended that language.

NAIC and many state regulators that GAO interviewed said that their primary motive for adopting the ISO endorsements was to protect insurer solvency. NAIC officials also told GAO that they have worked with ISO in developing a level of coverage that individual insurers could bear. NAIC agreed with insurers that without reinsurance, insurers' solvency could be at risk if they were required to provide insurance for terrorism. However, regulators told us that they were uncomfortable with ISO's original proposal to exclude all terrorism, from the first dollar of losses, because of the potential to exclude acts that may not be the result of terrorism. NAIC officials stated that the $25 million threshold was acceptable because it reflected the maximum losses that a single company could absorb. They told GAO that losses of $25 million born by a single insurer would threaten the solvency of 886 insurers representing approximately 44% of the P/C insurance companies writing commercial lines of insurance in the United States.

Some state regulators have not yet adopted ISO's terrorism exclusion endorsements for various reasons. These states include California, Florida, Georgia, New York and Texas. GAO interviewed these state regulators to obtain their views and concerns. In general, their concerns were related to the definition of terrorism, the loss thresholds for which coverage would apply, and the impact that such exclusions would have on small businesses in their states.

One state regulator maintained that ISO's definition of terrorism is overly broad, and could exclude insurance coverage of relatively minor incidents such as vandalism. ISO officials told us that the $25 million threshold, in effect, addresses lower levels of events that may come from domestic terrorism or vandalism. Another state regulator said the $25 million threshold is too low and that a minor incident in a central business district would trigger the total loss of coverage. One regulator found the exclusion language reasonable, but was concerned about the exposure small businesses would bear because they are least able to afford terrorism insurance.

ISO endorsements contain several key elements. One key aspect of the endorsements is its definition of terrorism. ISO's definition of a terrorist act provides that:

Terrorism means activities against persons, organizations or property of any nature:

1. That involve the following or preparation for the following:

- Use or threat of force or violence; or
- Commission or threat of a dangerous act; or
- Commission or threat of an act that interferes with or disrupts an electronic, communication, information, or mechanical system; and

2. When one or both of the following applies:

- The effect is to intimidate or coerce a government or the civilian population or any segment thereof, or to disrupt any segment of the economy; or
- It appears that the intent is to intimidate or coerce a government, or to further political, ideological, religious, social or economic objectives or to express (or express opposition to) a philosophy or ideology.

Although ISO's endorsements are commonly referred to as terrorism exclusions, they also contain language to define acts of war and to exclude war from coverage. While the endorsements' definition and application of the war exclusion did not change the war risk exclusion already used for commercial property lines, its application of the war exclusion was greatly extended for commercial general liability lines. ISO officials explained that historically, the war exclusion was limited to contractual liability in commercial general liability insurance lines, but now it will be applied much more broadly, similar to its application in commercial property lines.

A second key element of the ISO terrorism exclusion endorsements relates to the thresholds at which losses are excluded from coverage. The endorsements for both the commercial property and commercial general liability lines contain a $25 million loss threshold. Along with this threshold, the terrorism exclusion threshold for commercial general liability lines will also be met if an event causes death or serious injury to fifty or more people. Specifically, if a terrorism event causes aggregate damages of $25 million or less, insurance will cover insured property losses to policyholders.[1] However, if aggregate damages exceed $25 million, insurers will not be liable for any resulting losses, not even the first $25 million. In some urban centers the value of many individual buildings, even those not considered to be trophy properties, exceed $25 million.

The $25 million threshold has a geographic component, an insured damage and business interruption losses definition, and a timeframe definition. The geographic component specifies the geographic location of the damages that would aggregate towards the $25 million threshold. For

[1] Property damages and interruption losses at the damaged property.

commercial property lines of insurance, insured damages to all types of property located in the United States and its territories and possessions, Canada, and Puerto Rico would be included. For commercial general liability lines of insurance, ISO officials said damages anywhere worldwide would be included. The exclusion also states that "...all insured damages...and business interruption losses" would be added towards the $25 million threshold. ISO officials explained that "all insured damages" means damaged property that is covered by personal and commercial property insurance plus damage that would be covered by any insurance but for the application of any terrorism exclusions. "Business interruption losses" would be limited to properties that were damaged by a terrorism event. The exclusion further states that multiple events that occur within seventy-two hours and that appear to be carried out "in concert" are considered to be one incident. ISO officials explained that "in concert" means terrorism events that appear to be working together.

ISO exclusions provide an alternative fifty-person threshold for commercial general liability policies. If a terrorist event causes death or serious physical injury to fifty persons or more, insurance will not cover any losses to the policyholder, not even for the first fifty persons killed or seriously injured, and not even if aggregate damages are $25 million or less.

The thresholds do not apply to events of war, and use of nuclear, biological, and chemical agents of terrorism, any of which can trigger the exclusion of all commercial property and general liability coverage to the policyholder. For an exclusion of coverage, the ISO endorsements look at the intent of a terrorism event involving biological or chemical agents. If the intent of the terrorism is to release biological or chemical agents, insurance will not cover any losses to the policyholders. However, if biological or chemical agents were released in the course of any other incident, the $25 million threshold would apply, and the fifty-person threshold would apply for commercial general liability policies.

In an interview with the GAO, the National Association of Insurance Commissioners (NAIC) stressed that the ISO exclusionary language was meant as an interim solution to bring some level of certainty to the insurance marketplace while awaiting enactment of federal legislation. Accordingly, NAIC recommendation includes a sunset clause. Specifically, the sunset clause provides that the approval be withdrawn fifteen days after the President signs into law a federal backstop to address insurance losses attributed to acts of terrorism, consistent with state law.

TESTIMONY OF
NEW YORK STATE INSURANCE DEPARTMENT

BEFORE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

FEBRUARY 27, 2002

TESTIMONY BY GREGORY V. SERIO
SUPERINTENDENT OF INSURANCE
NEW YORK STATE INSURANCE DEPARTMENT

I. INTRODUCTION

Good afternoon. I'd like to thank you, Madam Chair, and all other Members of the Subcommittee for the opportunity to speak at this hearing.

In a matter of a few short, heartrending hours on September 11th, our nation's psyche and landscape were transformed by acts heretofore unimaginable. While more than five months have elapsed since that fateful day, we are still experiencing the effects of those vicious attacks. Our journey back from that dark morning has been filled with a sense of patriotism and a steadfast commitment to rebuilding what was destroyed, although nothing we can say or do will bring back the over 3,000 innocent lives lost that day. Much of this rebuilding will take place with resources provided by the insurance community.

However, rebuilding efforts will be compounded by the enormous complexities of a post-September 11th world. For us in New York, it is a recovery effort that continues amidst dialogues as how best to restore New York to its former glory. It is a dialogue on implementing initiatives that will promote with renewed vigor, the retention of financial services operations and jobs in the financial capital of the world, with a focus on rejuvenating lower Manhattan as both a premier business center and desirable residential community. It is also a dialogue, a very real dialogue, tinged with frustration and concern, on the continued availability of, and the sources for, commercial property insurance.

II. THE EFFECTS OF SEPTEMBER 11TH ON THE INSURANCE MARKETPLACE

The events of September 11th have had major repercussions in the insurance marketplace. Significant issues have been raised for both the industry and its regulators, none more important than that of addressing the issue of coverage for terrorist acts. This issue has manifested itself in myriad ways. Coverage for acts of terrorism is no longer available for the largest commercial risks and its availability in the small and medium-sized markets is spotty and, where available, is offset by dramatic increases in rates. Large buyers of insurance are no longer reaping the benefits of scale because the very characteristics - large number of employees, vehicle fleets, valuable real estate - that made them attractive to "cash-flow" underwriters prior to September 11th, are now making them undesirable to "risk-oriented" underwriters concerned especially with single-location concentrations of risk. In light of the events of September 11th and the subsequent threats of additional attacks on American targets on domestic and foreign soil, particularly by air, underwriters are reevaluating their risk management philosophies and underwriting practices to reflect their anxieties over the real and perceived threats of terrorism.

The most immediate and dramatic effects can be seen in coverage for large commercial structures. Stadiums, office towers, government facilities, landmark buildings, and other "trophy" properties, are generally written through less regulated markets such as the surplus (non-admitted) market or in special sections of the admitted market, such as New York's "Free Trade Zone", which allows freedom from rate and form regulation for high-value, sophisticated risks. In these markets, or in larger manuscript policies, rates and terms of coverage are largely matters for negotiation between the insurer and the insured. This coverage, where available, is now endorsed by terrorism exclusions and, even with the coverage narrowed by these exclusions, premiums have dramatically increased. Significantly, we have seen a substantial increase in surplus lines placements over the last five months for these types of properties as availability in the traditional admitted market has declined.

Corporate entities and real estate companies are not the only enterprises facing difficult insurance markets. Governments, too, are finding it either problematic to secure coverages or afford the premiums that are being charged. As with certain landmark properties and other sensitive venues, certain government facilities have been particularly hard hit by the recent trends in the insurance market. Some cities and towns are experiencing difficulties in obtaining coverage for their public buildings. In most small towns and cities across the nation, many high profile buildings, such as the town hall, public library and other buildings that house municipal facilities or are used as places of public assembly, are located within a short distance of each other. Despite efforts – and sizeable commitments of tax resources - to enhance security at such locations, insurers are now balking at covering these properties because they present an attractive target for terrorists and the geographical concentration of these buildings exposes insurers to large losses in the event of a single terrorist attack.

Some real life stories from the private and public sectors bring the issue into sharp relief.

A multinational telecommunications company has publicly declared that insurers do not want to write global polices for their high-value buildings. The company also has 80,000 vehicles which insurers are now wary of insuring as one fleet.

A $6 billion real estate trust has raised concerns about covenants contained in various indentures requiring adequate insurance coverage. If developers are unable to secure insurance that covers acts of terrorism, existing real estate lending arrangements will most likely be disrupted, new construction of major developments may stall and banking activity that funds these developments may suffer a setback.

Sports teams are also having trouble securing terrorism insurance. Across the country, insurers are offering significantly less coverage at substantially higher rates to professional sports teams in all venues. Insurers are concerned that the inherent characteristics of sporting events (i.e., high profile and the large number of people amassed at a single location) make them a prime target for a terrorist strike. As a case in point, it was reported that the New Jersey Sports and Exposition Authority, which manages Giants Stadium, saw its insurance costs more than triple to $2.4 million. As summer approaches, there are many other national and local events with a similar profile that could easily become a casualty of lack of terrorism insurance, namely state, country and trade fairs, as well as large conventions and expositions.

Hospitals were the first New York business sector to experience significant difficulties in obtaining adequate and affordable property coverage for their facilities post-September 11th. A major New York philanthropic organization, which operates a number of hospitals throughout the New York metropolitan area, provides a pointed example. The institution renewed its property insurance coverage on November 1, 2001 but was able to obtain only 20% of the expiring policy's coverage limits. Even this drastically reduced level of coverage was subject to broad terrorism exclusions and a tighter "occurrence" definition. The premium was three times higher and a total of 23 insurers, including 3 unlicensed insurers, had to be enlisted to secure one-fifth of the coverage supplied by a single insurer last year.

In the absence of an appropriate federal response to the issue of terrorism, consumers or their primary insurers will be ultimately left to assume and address the terrorism exposure. Carriers, already reeling from the record-setting losses attributable to the World Trade Center attack, will see a further deterioration of the industry's capital base in the event of a disaster – be it manmade or natural disaster – that results in even a fraction of the expected total loss from September 11th. Businesses and individuals will be forced to make economic choices when faced with suddenly higher premiums for less coverages or faced more dramatically with the notion of going without insurance for terrorist risk, i.e., covering the risk with their own resources. Many may well have to reconsider expansion plans in the works just months ago, consider reducing employee benefits, such as health insurance, consider the likelihood of securing lending without the availability of all-risk coverages, or consider amending the amount of insurance they carry in order to be able to afford the premium increases. A more drastic measure could be a decision to "go bare" and operate without insurance coverage, something many commercial entities have already decided as their only course of action. Some may even decide to adopt the risk management technique of "avoidance" by disengaging themselves from otherwise economically sound activities that may be subject to the peril of terrorism. In fact, we know of individuals and businesses vacating the upper floors of high rise buildings not only because they are unable to obtain appropriate insurance coverage but out of the additional concern for personal security and safety. None of these responses are desirable and their ramifications will certainly reverberate throughout our nation's economy.

The federal government must act quickly to address this situation with a goal of ensuring that our insurance marketplace remains sound in order to foster a full recovery from the September 11th events and to sustain the overall growth of the national economy. Federal action must not only take the form of a response to the insurance issues raised by the terrorism threat but should also include further actions to address ongoing concerns for personal safety, especially as it relates to the security of the skies. The New York State Insurance Department (Insurance Department) has been told that the insurance marketplace will be difficult to stabilize so long as there are continued real or perceived concerns about the security of the civil aviation system. In the insurance world, the perceptions of a threat could be just as important as a real threat. Stability in the insurance marketplace will be difficult to achieve if underwriters are not convinced that all necessary measures are being taken to secure the safety of our air transport system. Congress recently enacted legislation to address airport security and the impact of this piece of legislation will only be realized over time in terms of public confidence. So too will be its impact upon the confidence of insurers and their underwriters to return to the market.

III. CURRENT STATE OF AFFAIRS AND OUR RESPONSE

The Insurance Department estimate of losses arising from the September 11th events now stands at approximately $30 billion and $50 billion net and gross of reinsurance, respectively. Industry loss estimates may vary but by any measure this was a staggering event that will undoubtedly be recorded as the largest single insurance loss in the history of the insurance industry. The approximately $18 billion in losses resulting from Hurricane Andrew pale in comparison to the losses faced by the industry as a result of the events of September 11th. In fact, gross loss estimates for the September 11th events exceed combined losses from Hurricane Andrew ($18 billion) and the Northridge earthquake ($15 billion).

The insurance industry responded to the needs of its policyholders professionally and compassionately by providing critical funds sorely needed in the immediate aftermath of the disaster to rebuild devastated lives, businesses and properties. In general, contractual obligations were honored and insurance proceeds were paid to victims and their families promptly. Indeed, to date insurers have recorded better than $15 billion in claims reported or paid on better than 27,000 claims filed. To their credit, the industry did not resort to "act of war" or other exclusions to avoid paying claims. Despite certain misleading press reports, the sense of the Insurance Department is that the industry continues to approach its claims obligations responsibly. Any difficulties arising in the claims process, we have found, is usually from limitations on coverages, the collecting and evaluating of certain business records necessary to the claims process, or to the need to keep claim files open until all losses are determined.

Moving forward from the industry's response to the claims arising from September 11th has proven to be more problematic than the challenges of addressing the losses already incurred. For several months after the disaster, virtually all reinsurers, which are not subject to regulation by the individual states, excluded coverage for losses caused by acts of terrorism from contracts. While some flexibility was found in the renewals effective January 1, 2002, there was still widespread displacement in the market, particularly for large commercial risks. Along with this elimination of coverage for terrorist acts, there are dramatic increases in reinsurance premiums, and an overall reduction in the amount of coverage that the reinsurers would be willing to underwrite. While this development is expected in a hard insurance market, and while some may even attribute this to a certain amount of opportunism being exercised in the industry, by and large the impetus for this market dynamic appears to be the concern for providing coverage in the event of another terrorist attack or other large insurance event.

The lack of reinsurance capacity and the exclusions for terrorist acts has caused primary insurers to search for new avenues of capacity and to file their own terrorism exclusions for approval by the states. Consequently, within a month of the tragedy, primary insurers began filing proposed policy form amendments that would exclude coverage for any losses arising from the commission of a terrorist act on a virtually absolute basis. The Insurance Department has received 98 such filings to date. In addition to independent filings on behalf of 256 insurance companies, filings were received from the Insurance Services Office, Inc. (ISO), which generally serves as the property and casualty industry standard for policy terminology and practices.

Initial proposals of exclusionary language for acts of terrorism varied among the individual insurers that made the filings. Though they differed somewhat in the actual verbiage, the filings generally defined "terrorist acts" and the exclusionary "triggers" quite broadly. ISO's initial proposal was similarly broad in scope and approach. Following discussions with a special committee formed by the NAIC, ISO amended its proposal to define more narrowly the scope of the exclusion, most significantly by inserting a provision of $25 million in aggregate losses arising from a single act as the threshold for invoking the exclusion.

After careful review of the proposal, the Insurance Department, on January 24, 2002, disapproved ISO's filing pursuant to the controlling statute as being misleading and violative of the public policy of New York state, as is the standard of review under section 2307(b) of the New York Insurance Law. Among the reasons cited for the finding were:

- the unrealistically low aggregate loss threshold relative to property values in New York that would be likely to be affected by the exclusion;
- the inability of property owners to readily determine whether the exclusion actually applied to their insurance coverage, given the imprecise nature of loss estimation;
- the form's overly broad description of terrorist acts, which would likely exclude losses that, in the public's perception as well as in an insurer's original policy intent, would otherwise be expected to be covered; and
- the potential adverse effect that the exclusion would have on economic recovery in New York City and on general economic development throughout the state.

With the disapproval of ISO's form, we proceeded to disapprove all of the other pending filings.

While overly broad terrorism exclusions are not the appropriate solution, the Insurance Department recognizes that terrorist acts represent a catastrophic exposure that can not be retained by primary insurers without appropriate reinsurance. Requiring insurers to retain this exposure without the benefit of reinsurance or other mechanisms for laying off such risks raises serious solvency concerns, assures wider dysfunction of the property/casualty market, and may also result in possible violations of statutory "per risk" limitations. This concern is balanced against the equally compelling public policy priority of protecting businesses and consumers from being the last stop on the "pass the exposure express" Insurance regulators in a market as diverse and complex as that in New York must be the line of defense between insurers and those who would ultimately bear the risk. In the absence of a federal backstop for terrorism losses, which the Insurance Department believes is the single best mechanism to balance these competing issues, the Insurance Department will be compelled to consider exclusions, though we will continue to insist upon specific, targeted and well-defined terrorism exclusions that enable consumers and insurers to clearly understand the application of the exclusion and the substance of what is being omitted from coverage.

To be sure, the insurance marketplace was changing prior to the attacks on the United States last fall. The events of September 11th accelerated a previously developing hard market. The property/casualty insurance market has been largely unprofitable from an underwriting perspective for the last 4 or 5 years. The realization of adverse loss development has resulted in additional underwriting losses. These deteriorating underwriting results converged with declining investment returns, low interest rates and, of course, the occurrence of the first catastrophic event to implicate virtually all lines of insurance coverage, to create an unprecedented market challenge. Thus, it was only a matter of time before the industry's willingness to absorb these losses reached its saturation point, turning, and then propelling, the insurance cycle. As occurs in most hard market situations, insurers can be expected to do a complete reassessment of their business plans and underwriting standards. Lines of business and individual accounts that have experienced losses or have been otherwise unprofitable are now the subject of very close scrutiny and intense re-evaluation, even if such losses had nothing to do with events that occurred on that day in September.

As noted, the September 11th attacks and lack of reinsurance coverage for terrorism losses have primarily affected the property and casualty marketplace. However, the life and health insurance markets have not been immune to the fallout from September 11th. In recent discussions with several life insurers, we have been advised that catastrophic stop loss reinsurance coverage has become significantly more expensive while, at the same time, excluding acts of terrorism including nuclear, biological, and chemical incidents or attacks. The impact on the direct market (i.e., the cost and availability of life insurance coverage) is difficult to ascertain at this time. Several life insurers are considering whether this higher cost and more restrictive coverage is an effective and efficient way to manage their risks. In light of this development, life insurers are reassessing their geographic concentration of risks and exploring other alternatives in managing these risks. For example, some life insurers are considering altering their sales and marketing plans as a means of managing their risk concentration concerns.

Concern has been expressed regarding those who may have lost employer–sponsored health insurance coverage as a result of the September 11th tragedy. Loss of such coverage may be attributable to the termination of the employer's health plan, termination of employment, or for surviving spouses and dependents, the death of the employee.

Federal and state continuation laws (COBRA) permit former employees and surviving spouses and dependents to continue group coverage at their own expense when the employer group plan remains intact. They are also entitled under state conversion requirements to purchase the standardized HMO and point-of-service (POS) products available in the direct payment market. The HMO and POS contracts are also available when COBRA is not an option due to termination of the group plan. However, these options may be prohibitively expensive for many individuals. COBRA eligible individuals must pay the full group premium rate at their own expense, and the direct payment contracts in most cases are significantly more expensive than COBRA rates.

For those who have lost their employer sponsored health insurance, Healthy NY may be an attractive alternative to COBRA and conversion coverage. Available January 1st, 2001 as a part of HCRA 2000, Healthy NY offers eligible individuals a comprehensive health plan at premium rates made more affordable through a stop-loss funding mechanism established under HCRA 2000. Healthy NY may be particularly attractive to those whose only alternative is the direct payment conversion contracts.

Surviving dependents of a WTC victim would meet the eligibility criteria under a variety of scenarios. For example, Healthy NY is available if the surviving spouse is employed or becomes employed by an employer that does not offer group coverage, and the household income of the family is less than 250% of the federal poverty level at the time of application. Though survivors of WTC victims may believe that they are not eligible for Healthy NY because they were insured prior September 11th and/or because their household income was above 250% of the federal poverty level prior to September 11th, HCRA 2000 provides for exceptions to the general requirement that applicants be uninsured prior to the date of application. Loss of prior coverage due to death of a spouse and termination of prior group coverage are two such exceptions. In addition, Healthy NY considers current income. The situation of the survivors at the time of application is what is important. Healthy NY is designed to be helpful to those whose lives have been suddenly altered. I encourage employees and families affected by the disaster to visit www.healthyny.com or to call the Insurance Department for more information on Healthy NY.

Three insurers have also received Insurance Department approval to provide discretionary group status to the employees and survivors of victims that can not access COBRA benefits because the group contractholders (i.e., the employers) have ceased to exist as a result of the September 11th events. The three programs are summarized below:

- Oxford's Lower Manhattan Discretionary Group: Deadline for enrollment was either December 31, 2001, or January 31, 2002, depending on when group coverage was terminated. However, the Insurance Department, through discussions with the insurer, was successful in getting the enrollment deadline extended to April 1, 2002. To be eligible for coverage, a person must:

- have been an Oxford member on September 11, 2001; and
- work or have worked for a group located in lower Manhattan on or south of Canal Street (or is a covered spouse or dependent of such person); and
- have lost group coverage due to the group going out of business or because the group became unable to pay the insurance premiums as a result of the WTC tragedy.

- HIP's World Trade Center Continuation Rider: The original deadline for enrollment was January 31, 2002. Again, the Insurance Department, through discussions with the insurer, was successful was in getting this date extended to May 31, 2002. To be eligible for coverage, a person must:
  - have been a HIP group member at the time of the WTC tragedy; and
  - have lost health care coverage because his or her employer terminated a HIP small group policy as a result of the WTC tragedy; and
  - have been working for an employer located below Canal Street in Manhattan.
- Fidelis Hope Program: Deadline for enrollment is September 11, 2002. To be eligible for coverage, a person must:
  - have experienced unemployment, underemployment and/or the loss of health insurance coverage as a result of the WTC disaster; and
  - not be eligible for Medicaid or any government funded health insurance program; and

- be a New York State resident who works or resides in the "covered service area" (boroughs of Queens, Bronx, Brooklyn, Manhattan and Staten Island or Nassau, Suffolk, Westchester, Rockland, and Orange counties).

Gathering information on the impact of September 11th on consumers and the insurance industry was, and continues to be, a priority for the Insurance Department. To this end, and since the hours after the events on that day, the Insurance Department has pursued a course of action to monitor and respond to the rapidly changing market conditions. From eliciting signals of future market dynamics through the loss development arising out of the World Trade Center disaster and the claims practices of insurers in responding to it, to conducting statewide insurance marketplace forums concerning the availability and adequacy of coverage to homeowners, small businesses and large commercial risks throughout New York, to responding in timely fashion to the concerns of virtually every business group relating to adequacy of coverages, the Insurance Department has made an unprecedented commitment of resources to ascertaining the most current market conditions.

In the forums held on Long Island and Manhattan, consumers expressed concerns regarding the operation of property damage and business interruption coverage and the availability and affordability of renewal coverage. At the Albany forum held just this week, the Department heard from a steel merchant and fabricator in the Capital district; his story is representative of the concerns faced by businesses throughout the state. The company's general liability premiums skyrocketed from

$8,000 last year to $75,000 upon renewal this year; the premiums for their automobile coverage jumped from $31,000 to $56,000; and the umbrella policy premiums increased from $6,000 to $34,000. In all, this company's insurance bill for these coverages increased from $45,000 in 2001 to $165,000 in 2002, a 267% increase! To add insult to injury, the president of the company complained that while they began shopping around for these coverages months before they were due to expire, they were able to obtain only two quotations from the market just 4 days before the expiration date of their current policies. In 2001, they had the luxury to choose insurers and coverages from over a dozen quotations. In order to stay in business and fund this exorbitant increase in premiums, this company is contemplating raising costs to its fabrication customers by 10%. The company also considered lowering their insurance bill by getting out of the fabrication business entirely and focusing only on selling steel.

A representative from a nonprofit entity employing 25 people in the Wall Street area complained that premium costs for both primary and excess business liability coverage nearly doubled upon renewal. Although no claims were submitted as a result of the September 11th disaster or any other incident, the premium for the nonprofit's primary liability insurance policy rose from $32,000 to $60,000 for $1 million in coverage. The premium for the excess liability policy rose from $13,000 to $26,000 for the next $1 million in coverage. The representative testified that the broker was unable to secure better rates for this coverage in the market.

A representative of a large retailer of electronic equipment and computers employing 600 people in lower Manhattan stated that insurance premiums for all coverages pertaining to the business have, in total, increased over $1 million. The representative indicated that this increase in insurance premiums could jeopardize jobs and the future of the business in general.

This represents a small sampling of the numerous stories on how the disruptions in the insurance marketplace in the wake of September 11th are affecting the lives of real people. I believe these stories provide a poignant response to the question raised by the title of this hearing "How much are Americans at risk until Congress Passes Terrorism Insurance Protection?" Additional examples of the impact of the current crisis can be found in the transcript of the testimony presented at the forum held in Manhattan on February 21, 2002.

Our outreach to businesses was supplemented last week by the distribution of a survey of insurance issues related to the WTC disaster. The survey was hand-delivered by Insurance Department staff to all street-level businesses in the area south of Chambers Street and west of Broadway in lower Manhattan. Eighteen members of the Insurance Department, in teams of two, walked from door-to-door and handed out approximately 400 surveys with postage-paid return envelopes. Businesses were encouraged to bring any insurance-related issue or problem to the Insurance Department's attention either by completing and mailing the survey or by personally visiting our downtown offices.

In addition to gathering information from consumers, the Insurance Department sought information on the insurance industry's intentions regarding their pricing structure, coverage limits, exclusions, as well as their experiences in the marketplace. On December 3rd, a survey was sent to 69 insurer groups comprising some 389 companies that account for approximately 92% of commercial property insurance and 94% of personal property insurance writings in New York State. The purpose of this survey was to assist the Insurance Department in its continuing effort to closely monitor issues and developments affecting the availability of vital insurance coverages and the ability of insurers to maintain a viable presence in the marketplace. The survey required insurers to respond to several questions regarding their underwriting and rating plans, practices and intentions, and their experiences with reinsurance. Responses were received from companies that account for approximately 89% of commercial insurance and 93% of personal insurance writings in New York state. Following is an abstract of findings based on a compilation of the individual responses.

With respect to commercial property and liability insurance:

- 54% plan to reduce coverage limits on both new and renewal business;
- 12% plan to materially curtail the number of policies written in certain lines of business;
- 11% ceased writing or materially reduced the number of policies written in New York; 18% did so outside New York in 2001;
- 12% plan to cease writing or materially reduced the number of policies written in New York; 24% plan to do so outside New York in 2002;

- 81% of insurers responding that they are licensed to issue policies in the Free Trade Zone plan to exclude or limit coverage for acts of terrorism;
- 83% indicated that their reinsurers excluded or limited coverage for acts of terrorism;
- 32% indicated that their reinsurance premiums have increased by at least 10%;
- 64% indicated that their reinsurers reduced the limits they are offering;
- 27% indicated that their reinsurers increased coinsurance percentages;
- 38% indicated that their reinsurers increased required retention levels; and
- 95% indicated that they do not plan to materially reduce assumptions of reinsurance in 2002, however, the overwhelming majority indicated that they intend to exclude or otherwise limit coverage for acts of terrorism, to increase reinsurance premiums by at least 10%, and to reduce limits or increase coinsurance percentages.

With respect to personal lines (private passenger automobile and homeowners insurance):

- 20% plan to reduce coverage limits on some or all new business;
- 21% plan to reduce coverage limits on some or all renewal business;
- 5% plan to materially curtail the number of policies written in certain lines of business;
- 13% ceased writing or materially reduced the number of policies written in New York; 23% did so outside New York in 2001;

- 6% plan to cease writing or materially reduced the number of policies written in New York; 22% plan to do so outside New York in 2002;
- 14% indicated that they have or plan to seek approval to exclude or limit coverage for acts of terrorism;
- 78% indicated that they have or plan to increase premiums in New York;
- 54% indicated that their reinsurers excluded or limited coverage for acts of terrorism;
- 61% indicated that their reinsurance premiums have increased by at least 10%;
- 33% indicated that their reinsurers reduced the limits they are offering;
- 15% indicated that their reinsurers increased coinsurance percentages;
- 23% indicated that their reinsurers increased required retention levels; and
- All respondents indicated that while they do not plan to materially reduce assumptions of reinsurance in 2002; they intend to exclude or otherwise limit coverage for acts of terrorism, to increase reinsurance premiums by at least 10%, and to reduce limits or increase coinsurance percentages.

The above market survey was followed by an Insurance Department request for information on the underwriting practices employed by insurers in lower Manhattan. This request was prompted by reports that insurers may be restricting the writing of business in lower Manhattan by discouraging agents from submitting applications for new and/or renewal business. On February 15th, we requested information from 343 insurers (including 54 insurer groups) on their underwriting practices in Manhattan. The questionnaire requests information on applicable premium writings for personal and commercial automobile insurance, commercial multiple peril insurance, workers' compensation insurance, and homeowners insurance, on a monthly basis from January 2001 to the present. The reports are returnable on March 8, 2002. We are planning to follow this survey with a series of targeted market conduct investigations that will focus on insurers' cancellation, nonrenewal, underwriting and rating practices post-September 11th.

The Insurance Department is also in the process of establishing a Blue Ribbon Commission whose overall mission will be as follows:

- Analyze and compare the pre and post-September 11th conditions in the insurance marketplace throughout New York state;
- Identify the nature and extent of the insurance marketplace changes that (i) have arisen as a direct result of the September 11th disaster; (ii) were already taking place prior to September 11th and were affected by the disaster; and (iii) took place independently from the September 11th events;
- Consider availability and adequacy of coverages to homeowners, small businesses and large commercial risks in the New York market and changes arising in both availability and adequacy as a result of September 11th;
- Develop a strategy to increase the preparedness of the insurance community in handling future disasters or catastrophes; and
- Recommend appropriate legislative, regulatory and marketplace changes to address the identified issues.

In addition to any issues that Commission members shall identify, the Insurance Department has prepared a list of issues to be presented to the Commission for consideration. The composition of the Commission will be announced shortly. We expect the Commission to issue its recommendations by September 2002.

There have been many calls by legislators for the production of concrete evidence that the failure to enact a federal reinsurance backstop has resulted in a market upheaval. In response, I would like to submit that we have a developing crisis on our hands. To those who were expecting a sudden and precipitous market displacement, I would like to caution that because of market dynamics, the effects of a lack of a backstop for terrorism losses may be gradual and subtle, but just as detrimental. Rather than a sudden decapitation, the market effect may be analogous to a slow death by a thousand cuts for a variety of reasons.

There may be hesitancy on the part of many businesses to publicly acknowledge that they are conducting their affairs without the benefit of appropriate insurance protection. They are concerned, and genuinely so, that public disclosure of this information may adversely affect their client/customer base and put their business at a competitive disadvantage. Also, reinsurance programs typically contain various layers of coverage, with some layers possibly expiring on different dates and issued by separate reinsurers. While many reinsurance treaties expired on January 1, 2002, many other reinsurance contracts remain in force until April 1, 2002 or July 1, 2002. Accordingly, many primary insurers continue to have some reinsurance coverage for terrorist acts which may or may not be diminished because of the varying expiration dates of reinsurance contracts in successive layers of coverage.

IV. CONCLUSION

The insurance industry and their regulators are responding to the worst disaster in our nation's history. As discussed above, the events of September 11th have raised many issues that need to be resolved; however, none is more crucial than the lack of coverage for acts of terrorism.

Prior to September 11th, estimates of maximum probable loss for acts of terrorism were limited and comparable to other insurable losses. September 11th changed those calculations dramatically. A coverage that was essentially given away before September 11th became uninsurable post-September 11th.

The insurance industry does not have the capacity to absorb repeated losses such as the one inflicted on September 11th. The catastrophic nature of, and the potential of unlimited losses stemming from, this exposure make it impossible for the industry to bear this risk. Secondly, insurance rates are predicated on reasonable assumptions of loss frequency and severity. The frequency and severity of terrorism losses are impossible to predict. Therefore, even if we were to assume for a moment that the industry had infinite resources to pay for terrorism losses, it would be nearly impossible for the industry to develop an appropriate premium for the coverage using the sparse data currently available on terrorism losses in the United States. With a backstop for terrorism losses in place, insurers and reinsurers will be able to appropriately price the risk because they will know the extent of their exposure to terrorism.

Some may consider this to be solely a private sector issue, but it is not. The private sector, by itself, does not have the capability to develop a solution to this problem. I believe that the solution lies in a public/private partnership. Government participation is necessary because the nature of the risk has the potential to disrupt our national economy and presents a significant hurdle to recovery from the current recession. In the normal course of events, commercial activity that is transacted in our economy would not occur but for the availability of insurance and the ability of businesses to transfer the financial consequences of uncontrollable events to an insurer. Continued economic activity is dependent on well-functioning insurance markets and it is incumbent upon us, at both the state and federal level, to formulate an appropriate strategy to ensure that the insurance infrastructure remains sound and that public confidence in the insurance industry's ability to honor its promises is maintained.

To be sure, the Insurance Department and other state insurance regulators have taken the necessary measures to address pre and post-September 11th marketplace issues. These efforts were well under way prior to September 11th. However, many of the issues driving the current market, such as the public uncertainty about the security measures implemented to thwart future terrorist attacks and a general sense of insecurity prevailing in the civil aviation industry since September 11th, are not within the realm of insurance regulation and can only be tackled at the national level.

I strongly urge Congress to pass legislation that will, for a period of time, appropriately limit the industry's exposure to future terrorism losses. This will allow the industry to resume allocation of their resources to traditional insurance risks, including the ability to offer and price a level of terrorism coverage adequate to meet the legitimate needs and expectations of policyholders. It will also allow for the crafting of remedies to both the short and long-term weaknesses in the insurance system.

Thank you for allowing me the opportunity to testify today. I will be happy to answer any questions you have.

HOW MUCH ARE AMERICANS AT RISK UNTIL CONGRESS PASSES
TERRORISM INSURANCE LEGISLATION
STATEMENT BY DAVID L. MAIR
OF THE U.S. OLYMPIC COMMITTEE
AND THE RISK AND INSURANCE MANAGEMENT SOCIETY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

SUE KELLY, CHAIRWOMAN

February 27, 2002

Good afternoon Chairwoman Kelly, Congressman Gutierrez and Members of the Subcommittee. My name is David Mair. I am the Director for Risk Management for the U.S. Olympic Committee. I am also the President of the Risk and Insurance Management Society (RIMS), the largest professional organization for the risk management community. I appreciate the opportunity to appear before you today on an issue of vital importance to U.S. businesses and the U.S. economy – commercial insurance coverage for terrorism.

RIMS members – *the consumers of insurance* – include 84 percent of the Fortune 500 companies, as well as approximately 950 companies with less than 500 employees. RIMS represents over 4,000 *commercial policyholders*, many of whom are experiencing stratospheric property/casualty insurance renewal rates for significantly less coverage for terrorism. This situation is a result of insurance companies' inability to obtain reinsurance since January 1, stemming from the impossibility of predicting and pricing terrorist acts.

As a risk manager, my job is to measure threats to the physical, financial and human resources of the U.S. Olympic Committee. I must weigh these threats and determine the best possible ways to reduce them. One of the key elements of that process is the purchase of insurance. The insurance companies that I buy coverage from must be able to quantify the risk that my organization faces in order to prevent their own insolvency in the event of a catastrophe. In turn, the insurers spread the risk that they assume by obtaining reinsurance.

Fortunately for commercial policyholders and the U.S. economy, the industry was able to pay all claims from the September 11 attacks, despite the staggering costs. However, as with any business sector, this industry has limits on its financial capacity. Those limits, strained before the terrorist attacks, have been stretched even further.

The fallout from September 11, and its nearly $40-70 billion price tag, pushed the insurance market to its financial limits. It introduced a horrific, incalculable risk to the United States. It exceeded, in its human, financial and emotional devastation, all of our worst-case scenarios. And it has forever changed the insurance and reinsurance marketplace, impacting the U.S. economy and businesses to a much greater degree than many realize.

With the reinsurance market quickly vanishing at the end of 2001, insurers realized that they would have no outlet to spread the considerable risk present in a time of ongoing and increasing terrorist threats. Policyholders looking to the insurance industry for support against the potential for catastrophic situations faced a devastating new reality – the absence of coverage for losses related to terrorism. With reinsurers clearly declaring their intent to exclude this exposure, policyholders and the insurance industry turned to the government as a source for support in uncertain times.

As the expiration for most reinsurance contracts drew near and no federal backstop was approved, insurers did what they had to do to spread their risk and protect their solvency. They requested and obtained exclusions on terrorism coverage in commercial policies from state insurance departments. While the National Association of Insurance Commissioners expressed its hopes that such a step would not be necessary, when Congress was unable to enact this critical legislation, insurance commissioners in 46 jurisdictions let insurance companies out of the game. Commercial policyholders were not so fortunate.

So, now the buck has stopped with these policyholders – companies, large and small, in cities and rural areas that employ tens of millions of American workers. These businesses have, since January 1, assumed nearly all of the risk of owning commercial property and operating in a country that has been targeted for destruction by the most unpredictable type of enemy.

Coverage for the U.S. Olympic team was in place prior to September 11 under a long-term policy set to renew after the Olympic Games. However, at the end of November, one of our key insurers was downgraded. Suddenly, I found the USOC back at square one. Before September 11, terrorism coverage, an insurance line that many businesses had taken for granted, was a standard inclusion in most commercial property policies. Yet now, very few insurers offer it. Those that do are forced to price this coverage extremely high. It then becomes so unaffordable as to be generally unavailable.

After discussions with more than 40 different companies, the USOC was finally able to secure general liability coverage on February 9, the date of the Opening Ceremonies for the Olympic Games. We received two quotes, neither of which included terrorism coverage. We suffered a reduction in limits of 45 percent and a premium increase of 250 percent. Finally, on the day before the Salt Lake City Games and after working for almost 70 days, we were able to secure 5 percent of our expiring General Liability limit in terrorism coverage (with a B+ carrier) at 100 percent of our expiring premium, which left us significantly short of the amount of coverage we desire for terrorism insurance. Now we face a scheduled renewal for other lines of coverage, and we have received information that suggests further significant price increases and an absence of coverage for terrorism losses.

Our situation is similar to that faced by commercial policyholders across the country. I am here today to speak to you because the Olympic Winter Games have concluded without incident. And the significant risks, over which so many were concerned and to which so many resources were devoted, can now be spoken of publicly. Many of my risk management colleagues, at companies across America, and my fellow RIMS members, are not in the same position. They are still enduring an agonizing renewal process, or, more likely, their companies are concerned about shareholder reaction if their lack of terrorism coverage was publicly revealed.

How Much Are Americans At Risk Until Congress Passes Terrorism Insurance Legislation
Statement of the U.S. Olympic Committee and the Risk and Insurance Management Society
Subcommittee on Oversight and Investigations
Committee on Financial Services
February 27, 2002

Many U.S. businesses are being offered only $1,000,000 in terrorism coverage, in stark contrast to the hundreds of millions of dollars of terrorism coverage that they received in previous years, forcing these companies to bear extraordinary risk all on their own. Accounts of economic hardship among commercial policyholders are not relegated exclusively to those in "high-risk" areas; the affected membership of RIMS spans the country, and includes small, mid-sized, and large businesses.

Several RIMS members have, confidentially, provided our Society with information on how scarce, and prohibitively expensive, terrorism insurance has impacted their renewal process. Here are just two examples:

- A company in Georgia had all quotes from an October 1, 2001 renewal immediately withdrawn following the September 11 attacks. They finally placed blanket property coverage at the end of September with approximately 10 underwriters for 25 percent of the coverage they had the previous year.
- In Colorado, another company experienced a property insurance premium increase of 54 percent. Only $1,000,000 of terrorism coverage was offered to the company this year, versus the $250,000,000 that was available last year.

Financial institutions are also in an unenviable quandary. Some will claim that these companies are not calling in loans on large-scale properties. While there appears to be an absence of calls related to breach of loan covenants, it is not because coverage is being found. Simply put, financial institutions cannot call in loans on commercial properties that are now unable to obtain adequate insurance coverage because the banks do not want to absorb the entire risk of that uninsured property.

I commend those members of the House that voted to pass the terrorism insurance bill last November. I ask you to strongly encourage your colleagues in the Senate to approve their own legislation as soon as possible. The Senate itself was the victim of a terrorist attack last October when Majority Leader Daschle's office received a letter laced with anthrax. The Hart Senate Office Building was shut down for months; as a result Congressional staff was displaced and millions of dollars were expended in relocation and building clean-up. If this had happened to a private company, without the assets of the government, it would have been devastating, possibly putting them out of business.

Regularly, we hear of new threats to the security of our country, planned terrorist assaults to our cities that could become reality. The threats and the risks have not abated. The need for a federal reinsurance backstop is as critical today as it was in the fall, perhaps even more so as our economy struggles out of recession and the insurance markets fight to rebuild capital. How can the American business community, still reeling from September 11 and the economic downturn, be expected to assume all of the property risk in the war on terrorism? How do we explain to American workers that the construction sites and office buildings that they work in every day are not adequately covered in the event of a devastating attack? Or that future business projects, employee benefits, perhaps even their very jobs may be jeopardized?

How Much Are Americans At Risk Until Congress Passes Terrorism Insurance Legislation
Statement of the U.S. Olympic Committee and the Risk and Insurance Management Society
Subcommittee on Oversight and Investigations
Committee on Financial Services
February 27, 2002

I have full faith that the reinsurance markets will return eventually, and the industry will maintain its health and vibrancy. But until that time, we are taking an increasingly risky gamble with the financial foundation of American businesses. We are holding our collective breath that nothing else will happen. But if something does happen, U.S. companies – by extension their employees – will bear the consequences.

We have entered an era of unknown peril. The federal government is doing its utmost to see to the security of our borders and cities. These necessary defensive measures must include the stabilization of insurance markets and of the economy. This is not an issue of bailing out the insurance industry, but an issue of protecting and preserving our economy in the event of another major terrorist attack on the American people. Affordable and obtainable insurance is a hallmark of a healthy economy. Commercial policyholders request and deserve action on this issue.

Thank you for providing leadership at this critical time. I appreciate the opportunity to appear before you today.

Attachment 1 (of 2)

The Risk and Insurance Management Society, Inc. (RIMS)
Statement of Principles
On Terrorism Reinsurance Capacity

The United States economy, in all its sectors, including real estate, construction, manufacturing, financial and transportation, is dependent on adequate insurance coverage. Insurers, in turn, must be able to spread the risk that they assume on behalf of individuals and businesses by purchasing reinsurance. At the end of 2001, approximately 70 percent of all reinsurance policies expired. Due to the financial uncertainties of predicting terrorism activities, most reinsurers refuse to include terrorism coverage in 2002, leaving the insurance industry without the financial backstop that reinsurance provides.

It is imperative that Congress and the Bush administration take prompt action to maintain a robust insurance industry, which is crucial to assuring the continued strength of the U.S. economy. RIMS supports federal intervention to guarantee a viable property and casualty reinsurance source for U.S. policyholders. RIMS believes the following principles should determine the course of terrorism reinsurance legislation:

- **All insurers of U.S. policyholders, with domestic and international properties, should have access to an industry-driven reinsurance mechanism.**
  This mechanism would guarantee a viable property and casualty reinsurance source, stability for policyholders and a healthy insurance and reinsurance market. A voluntary reinsurance pool would allow the industry to build reserves in case of future terrorist attacks.

- **"Acts of terrorism" and "acts of war" need to be clearly defined.**
  Precise definitions are required to meet our new reality. The definition of both "acts of terrorism" and "acts of war" should include a state law pre-emption to eliminate conflicting interpretations.

- **Federal support for the insurance industry should be limited to five to six years.**
  Involvement by the federal government should be simple, clear and limited. As the world faces an unprecedented situation, the federal government should assume a temporary role to assist the insurance industry in the event that future terrorist acts deplete the industry's resources. However, the length of time should be long enough for the private markets to recover and become viable again.

- **Lines of coverage should not exclude business interruption or workers' compensation.**
  While property coverage is certainly required, business interruption and workers' compensation insurance are two of the most essential coverages in an organization's risk management program, and should be included in any federal reinsurance mechanism.

For more information, please contact RIMS External Affairs Department at 212-655-6046 or jwaldman@rims.org.

RIMS (http://www.rims.org) is a not-for-profit organization dedicated to advancing the theory and practice of risk management, a professional discipline vital to the protection and preservation of physical, financial and human resources. Founded in 1950, RIMS represents nearly 4,000 industrial, service, nonprofit, charitable, and governmental entities. 84% of the Fortune 500 companies are RIMS members. The Society serves 8,000 risk management professionals around the world.

TESTIMONY
DEBORAH B. BECK
EXECUTIVE VICE PRESIDENT
REAL ESTATE BOARD OF NEW YORK
FEBRUARY 27, 2002

THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

Chairman Kelly, Representative Gutierrez, distinguished members of the Subcommittee, thank you for the opportunity to appear before you on behalf of the real estate industry to make the case for a federally sponsored terrorism insurance mechanism.

I am Executive Vice President of the Real Estate Board of New York. My association represents over 5,000 of the leading owners, developers, brokers, property managers, banks, pension funds, utilities, architects, attorneys, and other individuals and institutions professionally involved in New York City realty. **I should add that a considerable portion of our membership also has interests in many other regions of the United States and globally.**

The lack of terrorism insurance poses a serious risk to our nation's economy, particularly to capital-intensive enterprises, such as real estate and industrial production, whose strength decisively affects job growth and consumer confidence.

Lenders demand terrorism coverage as an absolute condition for making large-scale commitments. For example, where real estate is concerned, lenders will not give loans for new construction, purchases, or "take-outs" on recently developed high-value buildings without such coverage. The unavailability of terrorism insurance prevents them from assessing the risk and pricing the loan accordingly. As a result, investment in real estate is faltering, which cannot help the country's efforts to emerge from a recession.

Here are the problem's broader dimensions:

As of January 1st, the reinsurance industry had eliminated terrorism coverage for 70% of its customers. By July 1st, unless things change, no insurance company in the world will have back-up reinsurance for terrorism coverage.

Without terrorism reinsurance, primary insurance companies will not take the risk of providing terrorism coverage for individual large properties or those concentrated around prominent properties in urban and suburban locations. As of now, regulators in 38 states have formally agreed to allow their insurers to exclude terrorism coverage from commercial policies. While some large states, such as California, have refused to allow the exclusion, the effect of that refusal is not yet known; it may cause insurers to cut back further on the kinds of insurance they will write in those states.

When we look just at the value of the large office and multiple dwelling unit buildings in major U.S. cities and consider what it would cost to rebuild them, it becomes clear that whatever terrorism coverage is available is woefully inadequate. Lenders are requiring full replacement cost terrorism coverage for these large buildings.

To put the problem in perspective, according to the national brokerage firm Cushman & Wakefield, there are 1.1 billion square feet of central business district office space across the nation. In New York City alone, there are 400 million square feet of office space with a conservative replacement cost of $160 billion. If you add to this the estimated $127 billion replacement cost of the 727,437 multiple dwelling units, you have a total terrorism insurance demand of close to $300 billion dollars in New York City, without taking into account terrorism coverage for other types of properties (e.g., universities, hospitals, places of worship, manufacturing and warehouse properties). We are informed that the terrorism insurance problem has already affected some major religious institutions in New York City.
We understand that the insurance companies offering terrorism coverage, and there are only four of them, have an aggregate of only approximately $10 billion available. This clearly falls far short of what is needed in New York City and the nation.

As a consequence of this insurance shortage, an expanding number of property owners in urban and suburban areas, in and around airports, near railroad stations, and in major shopping and recreational locations are unable to obtain terrorism insurance on high-value parcels (those worth over $50 million). This terrorism insurance exclusion also applies to buildings of lesser value located near what are considered to be potential terrorism targets.

Here are some specific examples of how various kinds of real estate activities have been thwarted recently for want of terrorism insurance. While these examples underscore the problems faced today by some larger businesses and institutions, they are also representative of the issues faced by smaller businesses throughout the nation. To honor our pledge of confidentiality, identifying information is omitted:

Case 1. National Office Portfolio

One of the first major real estate portfolios to go without terrorism coverage holds in excess of 25 million square feet of office and retail space in major cities across the country including Chicago, Minneapolis, Denver, Boston, and New York. The coverage came up for renewal just after 9/11. Prior to that time, the entire portfolio had blanket coverage of $1 billion. The old carrier would not renew any policies. The new carrier excluded terrorism coverage, and for the rest of the property coverage, charged a premium approximately four times that for the old full coverage policy. The only bid received for stand-alone terrorism coverage as of the end of January was from a small insurance company that quoted $25 million of coverage for a fee of $1 million. When the owners offered to take Manhattan properties out of the package to obtain terrorism coverage for the rest, they were rebuffed. Now, the owners are technically in default on their loan financing.

Case 2. Regional Office and Residential Property

The owners of a portfolio worth $3 billion, split between residential rental and office property in the Mid Atlantic and New England states, reports that they are receiving quotes for insurance that exclude terrorism coverage and are 5 times the amount they paid for full coverage in 2001. This business builds for its own portfolio and borrows against completed projects to produce capital for future buildings. **The company has 2,000 employees, many of whose jobs are at risk if the business is burdened with excessive insurance costs and risks.** Once the company's insurance expires next month, this firm will be in technical default on its mortgage agreements with over two dozen different lending institutions. A top-rated tenant has just moved into their most recently completed project under a 20-year lease. Despite the assured cash flow from this lease, as of late January, the owners could not get a mortgage on the property because available terrorism insurance coverage was capped at an amount below that required by the lender.

Case 3. Refinancing of Two New York City Office Buildings

A major investment bank agreed to refinance a $200 million mortgage on a one million square foot, top quality high-rise office building in Lower Manhattan that was not physically affected by the attack at the World Trade Center. A few days prior to the loan closing, the bank abruptly withdrew, saying its large loan committee had made a decision not to pursue such loans until terrorism insurance becomes available at a reasonable cost. As of late last week, lenders were expressing interest in the property but nothing is moving forward.

A second case came to my attention, and I have tried to understand why lenders are appearing to show interest when they will not commit to a loan under the present circumstances. The second office building is outside the borough of Manhattan, and is fully leased to a high credit tenant. The contemplated refinancing is similar in size to that for the Lower Manhattan building. While a few potential lenders are pursuing discussions, the mortgage brokers are concerned that the deal will fail once the discussion turns to insurance requirements. The mortgage brokers believe the lenders have deferred insurance discussions for now because the lenders, who want to be ready to make loans, hope that government will resolve the terrorism insurance issue before a firm commitment to lend must be made.

If these refinancings fail, not only will the owners suffer, but also the brokers will go unpaid. Moreover, mortgage brokers anticipate a drop in property values if this type of problem persists.

Case 4. Hotels

A hotel industry builder and owner firm with properties along the East Coast and in Chicago went through the insurance renewal process in early January and obtained terrorism coverage on only one $300 million property. That coverage was for $100 million and cost $3 million, 3% of the coverage. Even with that premium, the coverage included a deductible of $1 million and limited business interruption coverage to 30 days (after the owners covered the first 30 days).

The added insurance costs, including a 50% increase in workers compensation premiums, the reduction in tourism as a result of 9/11, and the inability to finance because lenders require full replacement "all risk" coverage, means that this builder will not do any new construction, and more unemployment will ensue. Since the average cost of these hotel projects is $300 million, the firm won't be able to create new jobs or add to local and state government revenues.

Case 5. Major Midtown Manhattan Office Sale

Inadequate terrorism coverage is holding up the sale of a Times Square building priced at $600 million. Shareholders, rating agencies and lenders insist on having terrorism insurance in place before the transaction can proceed. The prospective buyer's willingness to accept terrorism exposure for the uninsured portion is unacceptable to the lenders. Rates for the required insurance for the full purchase price are far beyond the buyer's means. Should the sale be cancelled, a loan in excess of $300 million will not be made, costing the originating bank fees and revenues, some of which would, inevitably, be committed to other job-generating, tax-producing business ventures.

The details of the coverage offered to date are telling. The buyers of the property have an existing blanket policy for the rest of their portfolio that was renewed before 9/11. Until then, new purchases were routinely added to the blanket policy. Now, however, this property has to be insured as a separate asset. The potential purchasers had to put down about 5% of the purchase price as a deposit knowing that if they could not prove due diligence in trying to obtain the "all risk" property coverage and the deal failed, they would lose around $30 million. A team of brokers and a consultant were put to work worldwide in an effort to patch together the required coverage.

The coverage bid so far looks like this: The insurer holding the buyer's existing blanket policy agreed to provide a first layer of terrorism coverage of $100 million for a fee in excess of $500,000, equal to 1/3 the amount they are paying for their entire blanket policy. The next insurer came in for $50 million over the first $100 million, for a fee of $500,000. These two insurers are providing $150 million of "all risk" coverage.

With a goal of $600 million in "all risk" coverage, without which the deal fails, the next two insurers bid on stand-alone terrorism insurance only. They offered to sell $150 million of terrorism insurance in excess of the first $150 million for $675,000. Another insurer bid to cover the remaining $450 million of non-terrorism coverage for $450,000. With an insurance bill at $2.125 million per year and rising, the buyer still has $300 million in terrorism insurance to go.

As of this writing, the deal is in danger of collapsing.

Case 6. Potential Default of a Major Mall

Just last week, a lender's representative, who had previously notified borrowers that they must maintain terrorism insurance, appears to have put one of America's largest malls West of the Mississippi in danger of default. The owners of the mall are actually numerous institutions and smaller investors in real estate funds. The owners have obtained a court order to restrain the lender from declaring the borrowers in default under the mortgage. The owners are disputing the lender representative's attempt to purchase exorbitant, but incomplete, terrorism insurance in response to the owner being unable to purchase its own reasonable and adequate coverage.

The lender's representative purchased $100 million of terrorism coverage at a cost of $750,000. This premium amount is three times greater than that for the all risk policy excluding terrorism put in place last month. In addition to the high cost, the owner would have a $5 million dollar deductible and would have no coverage if the act of terrorism were due to biological, chemical or radiation events. If the structure were to implode, as the twin towers did on 9/11, there would also be no coverage.

This example is thought to be the first of a series of test cases to be brought across the nation by this lender representative. If the courts agree that the representative does not have the right to act in this manner, it is assumed the next step will be for the representative to put the mall owner into default. Technically, any borrower required by the lender to carry terrorism coverage, and who cannot do so at reasonable cost, can be declared in default.

Case 7. University Research Laboratories

A major university's insurance coverage is up for renewal. It now appears that even if the university is able to obtain limited terrorism insurance coverage, that coverage will not extend to incidents involving the university's chemistry, biology, physics, and other laboratories. As a result, teaching and research activities at the university may have to be reconsidered, and perhaps restricted. One can only imagine the future cost to the nation in lost scientific advances if critical research and teaching activities do not occur.

Case 8. Construction of New Residential Building Stopped

As of last Friday, the developer of a proposed 30 story residential project in the Lincoln Center area of Manhattan had been unable to finance the construction due to the absence of terrorism insurance. This project would create 500 construction jobs, and cost $130 million to build. Unless the terrorism insurance can be found, this project will not go forward.

Conclusion

I'm sure that there have been, or soon will be, similar cases in **every district** represented by the members of this panel. As these examples illustrate, there is a compelling need for some federal mechanism to provide terrorism insurance, at least on a temporary basis.

For all its urgency, the lack of terrorism insurance has remained a silent crisis. Real estate owners haven't complained publicly because they don't want this situation to frighten the public or their tenants. Nor do they want it to be used by investors, lenders and potential purchasers as a justification for downgrading their asset values.

As previously noted, the reinsurance companies that provide back-up coverage have already withdrawn from 70 percent of the marketplace. Primary real estate insurance policies, written to be effective for twelve-month periods, are expiring on a staggered basis so that the full impact of the crisis is yet to be felt. **Owners whose policies will be in effect for another two or three months hope Congress will address the problem before they must obtain terrorism coverage.** Based on recent experience, these owners should have no reason to be optimistic. The first billion-dollar-plus realty portfolio lost its coverage in October. In the months since October, many more owners with multi-million dollar portfolios across the nation have told their professional associations that they have been unable to obtain terrorism coverage. Yet the Senate has not acted.

Here are the prospects for America's real estate industry and America's economy if remedial steps are not taken:

1. Sales of high-value property will be few as lenders decline to risk losing their loans and potential purchasers refuse to insure themselves for their full equity investment.

2. Sales prices will drop, reflecting increased risks.

3. Property assessments will drop dramatically. In turn, localities that depend on real property tax revenues will face harsh budgetary choices. Those governments will also sustain losses in transfer, mortgage recording and sales tax revenues because of the slowing realty market.

4. Owners in technical default on their existing mortgage agreements for failing to carry terrorism coverage will have to renegotiate these contracts, almost certainly at interest rates reflecting the lender's higher risk. Owners will also be compelled to take larger equity positions, limiting their capacity to do transactions.

5. As the cost of holding property becomes greater, owners will not have funds to make needed improvements or to invest in other properties.

6. The construction and rehabilitation work, essential to the employment of the building trades, will drastically diminish.

7. Lenders will provide less capital, declare owners in default of their mortgages if they do not have terrorism insurance, and might begin foreclosure proceedings if owners are unable to repay their loans. As a result, lending institutions' revenues will drop.

Only the federal government can provide a temporary back-up terrorism insurance coverage mechanism that will answer the economy's needs until owners and/or the insurance marketplace can price the risk and organize a solution. Such an initiative would not be a bailout for the insurance industry, it would be an effective defense to protect us, your constituents, from the economic aftershock of the September 11th terrorist attacks.

We look to Congress to do what is necessary to protect the nation's economic well-being.

The Lack of Terrorism Insurance and its impact upon Tax Revenue for New York

Prepared by Cushman& Wakefield's Financial Services Group

February 27, 2002

CUSHMAN & WAKEFIELD®

Introduction

Despite the ailing economy, significant capital remains available for the purchase of well located real estate assets in Manhattan. This strong demand is fueled by the historically low interest rates that are currently available for acquisition financing, and by the uncertainty surrounding alternative investments. In fact, every major Manhattan real estate offering since September 11 has been met with enthusiasm by the buying community.

Unfortunately, most of these offered transactions are not being completed due to lack of available terrorism insurance. Not only are investors reluctant to put their own capital at risk without this insurance, they are unable to reap the rewards of today's low interest rates because lending institutions are absolutely unwilling to finance an acquisition without proper insurance in place. Without financing, large transactions can not be completed (except, perhaps, by pension fund buyers who may not need financing but are bound by a fiduciary duty not to invest without proper insurance).

The irony of the situation is that the core assets that comprise New York's largest and most reliable real estate investments are the assets facing the most difficulty in terms of terrorism insurance. Thus, the most attractive acquisitions from an investment perspective are the most difficult to execute because of the perception that they are more likely targets of a future attack.

The result is that the large transactions that make up the bulk of acquisition-related tax revenues for the City and State and the Federal Government are not being completed. In addition, smaller transactions will be held up as well, adding to the tax shortfall. Unless the issue of terrorism insurance is addressed, the negative impact on tax revenues and therefore the economy will be severe.

Insurance Industry Reaction to September 11th

The catastrophic events of September 11th have caused the insurance industry to reexamine the types of coverage they provide to real estate assets. Specifically, as of January 1st, coverage for acts of terrorism were eliminated for 70% of policy holders. Even more shocking is that by July 1st of this year, no insurance company in the world will have reinsurance for terrorism coverage.

As of the end of January, regulators in 44 states have agreed to allow their regulated insurance firms to exclude acts of terrorism from their policies. Only California refused to allow this exemption.

The lack of insurance translates directly into the virtual cessation of the distribution of capital for new developments or acquisitions in major urban centers. In a time of budgetary crisis, this dearth of activity correlates directly to a reduction in tax income for both the City and State. Immediate legislative activity is necessary to reverse this fiscally devastating trend.

(Source: The Real Estate Board of New York, 2/15/02 Bulletin to Members)

Historical Transaction Volume

The following chart outlines the sales volume of major commercial office buildings in Manhattan as recorded by Cushman & Wakefield's Financial Services Group. While C&W only tracks transactions of $10 million or greater, these represent the assets most impacted by the lack of terrorism insurance. They also represent the most significant contributors to transaction-related tax revenues for the City and State. A simple average was calculate across four years to provide a basis for the likely volume for 2002.

Annual Sales Volume:	
2001	$11,561,876,295
2000	$6,695,980,671
1999	$6,155,351,939
1998	$6,011,402,000
Simple Average:	$7,606,152,726
Current Tax Rates:	
NY City Transfer Tax:	2.625%
NY State Transfer Tax:	0.400%
NY City Mortgage Tax:	1.750%
NY State Mortgage Tax:	1.000%

Potential City and State Revenue

In an effort to quantify the potential loss of tax revenue to both the City and the State, the following chart details how much revenue was received by the City and State for each of the prior four years from sales recorded in the C&W database. Since C&W cannot possibly record all the taxable activity, it is safe to assume that these figures represent the low end of the spectrum. As one can see, in a typical year the City receives over $265 million in taxes resulting from the transfer of real estate.

Legend:

CTT:	New York City Transfer Tax Revenue
STT:	New York State Transfer Tax Revenue
CMRT:	New York City Mortgage Recording Tax Revenue
SMRT:	New York State Mortgage Recording Tax Revenue

	CTT	STT	CMRT - 50% Debt*	SMRT 50% Debt*
2001	$303,499,252.74	$46,247,505.18	$101,166,417.58	$57,809,381.48
2000	$175,769,492.61	$26,783,922.68	$58,589,830.87	$33,479,903.36
1999	$161,577,988.40	$24,621,407.76	$53,859,329.47	$30,776,759.70
1998	$157,799,302.50	$24,045,608.00	$52,599,767.50	$30,057,010.00
Simple Average	$199,661,509.06	$30,424,610.91	$66,553,836.35	$38,030,763.63

* This is based on the assumption that 75% of the total value of the transactions will be financed, and that 25% of the transaction value is under a current mortgage. It is assumed that mortgage recording tax was already paid for the previously mortgaged portion and that the benefit of these paid taxes were assumed by the purchaser.

Lost Revenue on a Monthly Basis

Assuming only the following volume of deals actually close, versus the historical average, this is the potential for lost annual revenue in 2002:

	City Revenue	Lost City Revenue	State Revenue	Lost State Revenue
10% of the Average	$26,621,534.54	$239,593,810.88	$6,845,537.45	$61,609,837.08
20% of the Average	$53,243,069.08	$212,972,276.34	$13,691,074.91	$54,764,299.63
30% of the Average	$79,864,603.63	$186,350,741.79	$20,536,612.36	$47,918,762.18
40% of the Average	$106,486,138.17	$159,729,207.25	$27,382,149.81	$41,073,224.72
50% of the Average	$133,107,672.71	$133,107,672.71	$34,227,687.27	$34,227,687.27
60% of the Average	$159,729,207.25	$106,486,138.17	$41,073,224.72	$27,382,149.81
70% of the Average	$186,350,741.79	$79,864,603.63	$47,918,762.18	$20,536,612.36
80% of the Average	$212,972,276.34	$53,243,069.08	$54,764,299.63	$13,691,074.91

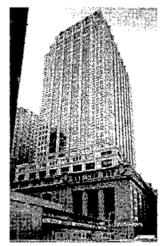
Potential Lost Revenue by Volume

Assuming an even dollar volume of transactions occur across 12 months,
this is the potential for lost revenue after each month that a solution to the problem is delayed:

	City Running Total	State Running Total
January	$22,184,612.12	$5,704,614.54
February	$44,369,224.24	$11,409,229.09
March	$66,553,836.35	$17,113,843.63
April	$88,738,448.47	$22,818,458.18
May	$110,923,060.59	$28,523,072.72
June	$133,107,672.71	$34,227,687.27
July	$155,292,284.83	$39,932,301.81
August	$177,476,896.95	$45,636,916.36
September	$199,661,509.06	$51,341,530.90
October	$221,846,121.18	$57,046,145.45
November	$244,030,733.30	$62,750,759.99
December	$266,215,345.42	$68,455,374.54

Case Studies

The following two transactions are examples of the plight facing the current real estate market. For each, there is a ready and willing buyer 'at the table' but unfortunately these deals reportedly cannot close for no other reason than the lack of available terrorism insurance.

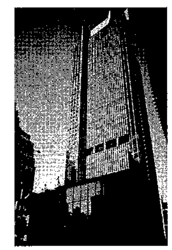


450 Lexington Avenue

450 Lexington Avenue is under contract for $335,000,000*. This represents the following revenue should the deal close:

$8,767,500 in City Transfer Tax
$1,336,000 in State Transfer Tax
$4,987,500 in City Mortgage Recording Tax**
$2,850,000 in State Mortgage Recording Tax**

(*As reported in the market)
(** Based on $285 million



1515 Broadway

1515 Broadway is under contract for $496,000,000*. This represents the following revenue should the deal close:

$12,993,750 in City Transfer Tax
$1,980,000 in State Transfer Tax
$5,642,000 in City Mortgage Recording Tax**
$3,224,000 in State Mortgage Recording Tax**

(*As reported in the market)
(**Assuming 65% debt)

Conclusion

While some may argue that the notable lack of transactions for 2002 is a result of the economy, it is our opinion that this is simply not the case. There is no shortage of equity capital available, and financing rates are more favorable now than in the past. As the preceding case studies demonstrated, there are buyers waiting with capital in hand, they simply cannot execute the transaction for no other reason than the lack of terrorism insurance. The table below represents the cumulative tax revenue that is at risk of being lost in New York City in 2002 alone should this urgent issue not be addressed in a timely manner.

Average tax revenue received from the sales of commercial office buildings in Manhattan:	
Average Annual Total Revenue to NY City:	$266,215,345.42
Average Annual Total Revenue to NY State:	$68,455,374.54
Average Monthy NY City Revenue:	$22,184,612.12
Average Monthly NY State Revenue:	$5,704,614.54

Disclaimer

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Deborah B. Beck, Executive Vice President
Real Estate Board of New York
Response to questions posed by Rep. Luis V. Gutierrez, Ranking Member
Oversight and Investigations Subcommittee Hearing
"How Much are Americans at Risk Until Congress Passes Terrorism Insurance Protection"
Questions for the Congressional Record
2/27/02

1. A federally backed reinsurance pool for terrorism coverage where insurers pool their capital for a layer of reinsurance and rely on the government to cover terrorism related losses in excess of funds available in the pool is not an option if the insurance industry is unwilling to participate. Further, such an option would take a long time to structure. The problem for large value real property exists today. That is why it is imperative for the Senate to act on a bill and the Congress to agree on final legislation to provide temporary back up insurance for acts of terrorism including those caused by biological, nuclear or chemical sources.
2. In my judgement, it will take at least 2-3 years for the primary and reinsurance market to estimate its ability to provide protection from acts of terrorism. Indeed, if we should experience additional acts of terrorism in the interim, the insurance industry is unlikely to return to the marketplace for large value properties.
3. While the capitalization of the industry appears adequate to fulfill its current obligations such as those incurred on 9/11/01, there is no certainty that this financial base will be sufficient to cover a multitude of catastrophic events be they caused by nature or terrorism. In my opinion, government cannot force a private entity to sell a product it can not or will not produce.
4. The reinsurance industry notified its customers, the primary insurers, in writing, last fall that it intended to fully withdraw from the market for reinsurance for acts of terrorism by July 1, 2002. As of January 1, 2002, 70% of the re insurers had not renewed such coverage. The remaining 30% of the treaties in effect are set to expire over the course of the next few months with the last ones expiring at the end of June.

LISA KRAMER
President & CEO
FOJP Service Corporation

Hearing Before the Subcommittee on Oversight and Investigations
"How much are Americans at risk until Congress passes terrorism insurance protection?"

Wednesday, February 27, 2002, @ 3 p.m.
Rayburn House Office Building, Room 2128

Lisa Kramer Testimony

Good afternoon Chairwoman Kelly, ranking member Gutierrez and other members of the Subcommittee on Oversight and Investigations.

I am the President of FOJP Service Corporation. FOJP is a non-profit membership corporation, incorporated under the New York Not-For-Profit Corporation Law. We serve as risk management advisors to United Jewish Appeal-Federation of Jewish Philanthropies of New York and its beneficiaries, among which are six major academic medical centers, many long-term-care facilities, and 110 social service agencies, community centers, Ys and camps. FOJP's Board of Directors, which is elected by UJA-Federation, is comprised of men and women with diverse professional backgrounds who also serve on the Boards of institutions that are represented by FOJP.

These institutions are at the forefront of providing cutting edge medical care; a broad array of mental health services; cultural, educational and physical fitness programs; services for the elderly and for immigrants; camping and daycare for the young and for the old; and employment counseling and training for those seeking jobs. Services are provided on a non-sectarian basis to a population that reflects the diversity that New York State is known for, and often to people who have nowhere else to turn. Our facilities provide housing for the elderly, counsel to victims of domestic violence, rehabilitation to the deaf and to the deaf-blind, and health care to millions of people year in and year out.

In its capacity as risk management advisor to these institutions, FOJP works with leading insurance brokers to procure lines of property and casualty insurance coverage that are essential to protect the institutions from liabilities and losses. Professional medical liability, commercial general liability, workers' compensation and all-risk property insurance are among the lines of coverage procured through the FOJP program.

In May of 2001, through two of the largest insurance brokers in the world, FOJP began the process of marketing the renewal of the all-risk property insurance that covers loss of or damage to the real property of its client institutions--property valued in excess of $8.5 billion. The renewal date was November 1, 2001.

In July of 2001, each of the brokers was awarded seven of the world's largest and most respected property insurers to which to market the FOJP property coverage. Sealed bids were due on September 17. The brokers were actively in the process of seeking renewal quotations when the attacks of September 11 took place.

An already hardening property/casualty insurance marketplace became a nightmare for insurance consumers. And, in agreement with its brokers, FOJP stopped the competitive bidding process and used one broker to scratch and claw the worldwide insurance market for a renewal program.

Prior to the November 1 renewal, institutions insured through the FOJP program enjoyed property insurance limits of over $8 billion for the program. Following the November 1 renewal, and despite the extraordinary efforts of one of the world's largest insurance brokers on the worldwide insurance market, 16 international insurance companies in combination provided a program with significantly less coverage at significantly increased cost. Most alarming, however, was that terrorism exclusions were added to their policies.

Upstate hospitals, particularly in the Buffalo and Albany areas, have seen their insurance limits dramatically reduced, both their deductibles and premiums dramatically increased, and all had terrorism exclusions inserted in their policies.

The combination of significantly reduced limits and terrorism exclusions experienced by the FOJP program has become commonplace, posing a serious threat to the ability of non-profit healthcare and social services institutions to continue to provide the services that are so important to the poor, the aged, the sick, the disabled and to those of us who are lucky enough to enjoy cultural and educational services without the burden of sickness and disability.

Consider that each of FOJP's largest hospital clients have in excess of $500 million in long-term debt, as well as more than $100 million in short-term loans for new construction. In the event that one single terrorist act, even far below the magnitude of September 11, seriously damages or destroys any significant property in the United States, the effects of such a scenario could be far reaching and devastating.

Lender agencies will realize that they are the insurer of last resort. Institutions will be unable to rebuild because of terrorism exclusions and there will be defaults to private mortgagees and government lenders. Lenders may respond by requiring terrorism coverage before lending any additional money to similar institutions. The institutions will then face the choice of foregoing essential programs that are necessary to fulfill their missions, or paying exorbitant terrorism premiums for insufficient coverage limits. A leading writer of terrorism coverage recently quoted the FOJP program a premium of $4,236,080 for $50 million in coverage.

Premiums of this size are simply not affordable in the current fiscal environment. Leaving aside the day-to-day financial stress non-profit institutions bear in providing essential services, basic insurance costs--for property, liability, and statutorily required coverages--are rising precipitously. There is no money in any budget to pay the premiums that are being quoted for terrorism coverage, if such coverage can be found at all.

And even if the money could be found, the limits being offered are seriously inadequate. As I noted, the FOJP program was offered $50 million in coverage--no more. If one of our insured hospitals were to be seriously damaged or destroyed by a terrorist act, $50 million in coverage would make but a small dent in the hospital's financial obligations and rebuilding costs.

The issue of insurance coverage for property loss caused by acts of terrorism is a serious one. Coverage is either unavailable or coverage that is available is inadequate in limits and unaffordable in price. We need Congress to act and to act quickly.

Thank you.

Lisa Kramer

Lisa Kramer, President and CEO of FOJP Service Corporation, joined the company in September, 2000, bringing with her 30 years experience in the insurance business. She is also President and a member of the Board of HANYS Insurance Company, Inc., a New York State-licensed property/casualty company.

During the ten years before she came to FOJP, Ms. Kramer was an executive with the MIIX Group of Companies, which provides medical malpractice insurance for doctors and healthcare institutions. Before joining MIIX, Ms. Kramer was a senior management consultant at Tillinghast, a Towers Perrin company, where she consulted with Fortune 500 companies, insurers and reinsurers on claims and litigation management, legal expense control, organizational effectiveness and strategic planning.

From 1978 to 1984, Ms. Kramer was a vice president at CIGNA Corporation and ran its litigation and government relations departments for the property/casualty group. Prior to CIGNA, Ms. Kramer was a trial lawyer at Ballard, Spahr, Andrews and Ingersoll, a large law firm in Philadelphia, specializing in medical malpractice, products liability and insurance coverage cases.

Ms. Kramer received both her B.A and J.D. degrees from the University of Pennsylvania and its law school. She is a member of *Phi Beta Kappa*, the International Association of Defense Counsel and the American Bar Association. She has published articles and lectured to industry and trade associations on claims and litigation management.

Reply to Congressman Luis V. Gutierrez Questions

1. Changes in the terrorism insurance market are likely to affect philanthropies and charities in two principal ways:

a. Lack of Coverage. Philanthropies and charities cannot afford to purchase terrorism coverage at current market rates and, as a consequence, are uninsured for terrorism-related losses. A recent coverage quotation received by the FOJP insurance program was $4.2 million for $50 million in coverage. Even if this premium were affordable, the limits are insufficient to rebuild many properties located in the New York metropolitan area. The uninsured terrorist exposures now presented to philanthropies and charities are particularly troubling in light of the fact that these institutions often host fundraisers and other functions attended by heads of state, politicians and dignitaries, with ample press coverage, that make these locations possible targets for terrorist acts.

b. Terrorism-Related Losses. In the event of uncovered terrorism-related losses, it is highly unlikely that non-profit institutions will have the ability to rebuild. This will, of course, have a direct and devastating impact on the people (clients, patients, etc.) these institutions serve.

2. Non-profit healthcare and social service institutions are disproportionately affected by the post 9-11 insurance market because of their limited budgets. These institutions don't have the money to buy insurance and, at the same time, to keep staffing and services at optimum levels. In addition, they are not able to bear uninsured risk in the same way their for-profit counterparts can, and, in most instances, they don't have the capital to finance alternative risk mechanisms.

3. In the event of large losses or terrorism losses that are not covered by insurance, many hospitals and social service institutions will, in my view, be forced to eliminate or reduce vital services that are provided to their patients and clients. As noted above, institutions will either not be able to rebuild or will be forced to divert funds, which are needed for the provision of services, to the rebuilding process. While I have not yet seen large losses or terrorism losses that have resulted in this scenario, what is already occurring is the need to divert funds from staffing and services to pay commercial insurance premiums. In addition, lending institutions have already begun to require evidence of terrorism coverage before providing financing for new building projects or for expansion or improvement of existing structures. This requirement, where non-negotiable, puts social service agencies and hospitals in the position of having to buy commercially available terrorism coverage at the current exorbitant rates or forego expansion and improvement.

4. Spread of risk is essential if commercial insurance carriers are to begin to offer the limits and coverages that are needed at affordable prices. Federal intervention is essential in order to achieve the necessary spread of risk.

The Premier Association of Real Estate Finance

Mortgage Bankers Association of America
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STATEMENT OF

Kieran Quinn

President & CEO
Column Financial, Inc.
A subsidiary of Credit Suisse First Boston

on behalf of
Mortgage Bankers Association of America

before the
Subcommittee on Oversight and Investigations
Committee on Financial Services

U. S. House of Representatives

Hearing:
"How Much Are Americans at Risk Until Congress Passes Terrorism Insurance Protection?"

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February 27, 2002

Good afternoon, Madam Chairwoman and Members of the Committee, I appreciate the opportunity to be here today to discuss the terrorism insurance issue and its consequent effects on the commercial real estate finance industry. My name is Kieran Quinn. I am the President and CEO of Column Financial, Inc., in Atlanta, Georgia, a subsidiary of Credit Suisse First Boston. I am here today on behalf of the Mortgage Bankers Association of America (MBA)[1].

First, I want to thank you for inviting the MBA into this very important discussion on a very urgent matter. I commend the Committee's leadership in calling for these hearings, as we believe that a full understanding of the issue is the only responsible way to finding solutions. The lack of terrorism insurance is a barrier to conducting business in the commercial real estate sector, and we urge Congress to work with industry to craft a workable solution to this problem. A failure to address this situation will have negative consequences for the economy.

[1] MBA is the premier trade association representing the real estate finance industry. Headquartered in Washington, DC., the association works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership prospects through increased affordability, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate professionals through a wide range of educational programs and technical publications. Its membership of approximately 3,100 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field.

During 2001, Column Financial closed 549 individual loans, totaling $5.8 billion. The smallest loan was approximately $1 million and the largest loan was $480 million. Today we will not consider any loans in excess of $50 million without full terrorism insurance coverage and we are scrutinizing all loans in excess of $20 million if they have any terrorism exclusions. Recently, I have turned down six loans valued at approximately $300 million, and have discouraged many more. My competitors are acting likewise, and the current situation is only going to get worse. High-rise office buildings in high profile cities such as New York, Washington, Chicago and Los Angeles would be extremely difficult to finance without terrorism coverage. If another attack occurs the markets will shut down.

To put the commercial real estate financial industry in perspective, total outstanding commercial mortgage debt equals $1.7 trillion. The real estate finance industry provides the strong tax base that allows communities to thrive. Property taxes alone provide almost half of all local government funding and more than 70 percent of the local tax base throughout the country. The construction and real estate industries create hundreds of thousands of jobs, which benefit local communities. The real estate industry contributes 11 percent of the gross domestic product, making it the fourth largest industry contributor after manufacturing, tertiary, and entire government sectors.

Undeniably, 2001 was a record setting year for commercial and multifamily real estate loan production. The reasons for this success are varied, but are tied to the historically low interest rate environment; the relatively shallow nature of the recession; and the lack of overbuilding. Furthermore, many loans were already in the pipeline before September 11, but more importantly, most lenders and originators continued to lend, based on their confidence that Congress would act and pass a terrorism reinsurance backstop.

Loan production volumes for 2002 will be at risk if terrorism insurance coverage remains unavailable. For example, during 2001, commercial real estate finance activity in Chicago was approximately $10 billion dollars; in New York it was $12 billion; and in Los Angeles it was $10 billion. This is not only a loss of business for lenders and developers--it also represents a loss of construction jobs, and a loss of transfer taxes to the locality. Furthermore, since pension funds and life insurance companies have a significant amount of their investors' money in commercial real estate holdings and commercial mortgage backed securities, if there is a downturn in the commercial real estate industry average Americans will be adversely affected.

Currently, there is a risk transfer occurring from the insurance industry to commercial businesses. Insurance commissioners in 45 states have approved exclusions for terrorism, war and military action, and the use of nuclear, biological or chemical materials. This risk is being transferred to borrowers and lenders, thus making the lenders the insurers of last resort. If this situation remains, lenders will not be able continue to make loans.

I am here today to say that lending capacity, in the industry as a whole, in 2002 is being dramatically affected by the lack of available terrorism insurance coverage. My company is not the only lending institution affected. The Mortgage Bankers Association of America (MBA), of which I am a member, has been conducting an industry-wide survey of its members and has collected anecdotal information regarding lost business opportunities and additional procedures now required as a consequence of the unavailability of terrorism insurance.

For example, several Manhattan high-rise projects, whose collective values equal about $1 billion, have lost funding because terrorism insurance could not be obtained. One of the nation's largest commercial and multifamily lenders has sent a company-wide memo stating that no loans should be made over $25 million without strict scrutiny of potential terrorism risk.

Many servicers of commercial mortgage backed securities (CMBS) have concerns about insurance coverage on existing issuances. If the same insurance coverage is not available when policies are renewed, there is a possibility that loan covenants have been violated because the required all risk coverage will not be provided. If this is case, the bondholders may have the option of selling back the bonds to the issuer. During 2001, new CMBS issuances totaled $97 billion. A massive sale back of these bonds could have a profound effect on the safety and soundness of the banking industry.

A major commercial mortgage lender with a $10 billion portfolio and who originates large loans for securitization has decided it must protect itself by requiring terrorism insurance on all its current and new loans. Borrowers frequently are unable to obtain the required terrorism insurance making it impossible for the lender to close the loan. This situation is creating strains on long-term lender-borrower relationships and requires hiring large numbers of additional staff to review insurance policies for required coverage. In addition, many borrowers appear to be in technical default on their mortgages because they cannot obtain adequate insurance coverage. Many hours of staff and legal time have been taken up on the question of what it might mean to throw so many properties into technical default.

Rating agencies are also reacting to the lack of available terrorism insurance. Fitch IBCA, Duff & Phelps and Moody's are in the process of creating new criteria to categorize risk. If Congress fails to pass legislation, these new guidelines would likely cause rating downgrades in new, outstanding and existing deals. Among the high-risk properties are trophy assets; large gathering venues, such as stadiums, arenas and major retail centers; infrastructure, such as bridges and tunnels; and energy providing structures. In addition, special scrutiny is being given to otherwise run of the mill properties that are in close proximity to such structures. Under these new guidelines, Moody's is factoring the extent of insurance coverage, the amount of the deductible, the prominence of the real estate and the likelihood that a property may be the target of a terrorist attack. Fitch has stated tall buildings located in densely populated central business districts or buildings with high-profile tenants may also be categorized as a high-risk property. These actions taken by the rating agencies will increase spreads and subordination levels that will result in diminishing returns to issuers.

I am a commercial real estate lender and that means that I am trained to assess and price risk. I do not get them all right, but I get enough right that I have been successful over the years. But I am trained to deal with certain types of risks. For example, K-Mart has announced that they are walking away from 335 major retail leases across the country, a significant potential loss for the properties and developers involved, but the commercial real estate industry is prepared to deal with this type of event.

The problem is that we have no training in how to assess and price the risk of terrorist acts. I can assess and price the risk of a K-Mart bankruptcy, or I can buy insurance against the risk of a building burning down. But if I cannot assess the risk, and borrowers are unable obtain insurance, I will not do the deal, particularly when various government officials continue to state that the chance of another terrorist attack is 100%.

I submit that the time to act is now, before another terrorist incident occurs. Act now while you have the luxury of being able to give careful consideration of how such a program should be crafted. Act now before the absence of terrorism has the profound effect of limiting new commercial and multifamily real estate financing which has been one of the sectors that has performed well during the recessionary period. I must underscore this is an economic issue. The need and purpose of a government reinsurance backstop is to stabilize the markets. If and when another attack occurs, a federal backstop will ensure against market disruption and panic.

Currently, the stalemate in the legislative process has created a hold on capital flow in the commercial real estate markets. Further economic growth is being held hostage to legislative indecision that will, in turn, create and prolong an economic downturn. Despite the volatility if the financial markets and the lack of growth in most sectors of the economy, the real estate industry remains vibrant. Moreover, I believe that real estate can serve as the engine for restoring our nation's economic health and vitality. Indeed, the entire real estate industry employs more than 8.5 million people. We need to preserve real estate's role in fostering economic growth, and also unleash its potential to do even more.

While I do not feel qualified to comment on specific legislative provisions, I urge Congress to pass terrorism reinsurance backstop legislation and I want to applaud the Financial Services Committee for taking the lead in this area.

Thank you for the opportunity to testify. I will be happy to answer any questions Members of the Committee may have.

CFA Consumer Federation of America

STATEMENT OF J. ROBERT HUNTER
DIRECTOR OF INSURANCE
BEFORE THE OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE
OF THE HOUSE FINANCIAL SERVICES COMMITTEE
ON THE TERRORISM INSURANCE MARKET
SINCE SEPTEMBER 11TH
FEBRUARY 27, 2002

Madame Chair and Members of the Subcommittee, I appreciate your invitation to testify before you today. I am the Director of Insurance for the Consumer Federation of America.[1]

You will recall that CFA was a prime supporter of legislation to back-up the insurance industry for terrorism. Indeed, I testified before two Senate Committees that I thought it was too risky to wait to see if the lack of federal back-up would produce significant economic damage to America.

But Congress failed to act. As a result, we now have some initial knowledge of how the market will respond. The problems we see in the insurance market due to the failure of Congress to enact a terrorism insurance back-up are far less than expected.

CFA Study of the Insurance Market

To reach this conclusion, CFA undertook a major study of the insurance market after January 1, 2002. A copy of that study, which was released on January 23, 2002, is attached to my testimony. Our major findings were as follows:

1. The insurance industry is wealthy and overcapitalized.

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[1] CFA is a non-profit association of more than 280 organizations that, since 1968, has sought to advance the consumer interest through advocacy and education.

2. High rates are a problem for mid-sized and larger firms.
3. The larger firms are finding alternative ways to deal with the problem such as self-insurance, creation of captive insurance companies and securitization.
4. The rate problem is caused by a classic turn in the economic cycle of the industry, sped up by – but not caused by --the terrorist attacks.
5. The hard market is anticipated to be shorter than usual because of the excess capital in the insurance industry.
6. Banks are freely loaning money to the vast majority of – if not all – businesses, regardless of the terrorism insurance situation in the nation.
7. There are presently no other widespread economic problems related to the terrorism insurance situation in America.

The losses from the World Trade Center attack will be about half to three-quarters of what the insurers predicted, amounting to $35 billion, or $23 billion after tax considerations, according to the New York Insurance Department. While this is the largest dollar loss ever, the impact on the industry's bottom line was 7.2% of the industry's cash surplus, not much more than the 6.3% hit from Hurricane Andrew." [2]

A remarkable finding is that the insurance industry is at least as strongly capitalized as before September 11th. The capital lost to terrorism was about $23 billion, but the new capital already booked by the industry since September 11th in anticipation of large profits from large price hikes, is over $24 billion. To be sure, the "lost" capital and the "new" capital are not necessarily in the same insurance companies, but the industry as a whole is more strongly capitalized now than when the terrorists struck – surely a victory for capitalism over terrorism. At least six new companies have been formed. The average stock price for the seven largest insurers has increased by 4.8% since the closing stock price of September 10th, an annual rate of increase of 11.5%.[3]

This is not to say there are no problems in the market. The biggest concern is high insurance rates for businesses.

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[2] Calculated by dividing the after-tax insured loss by the beginning of year surplus of the property/casualty primary market. This overstates the impact on the primary market in that reinsurers will pay a large percentage of the after-tax loss.

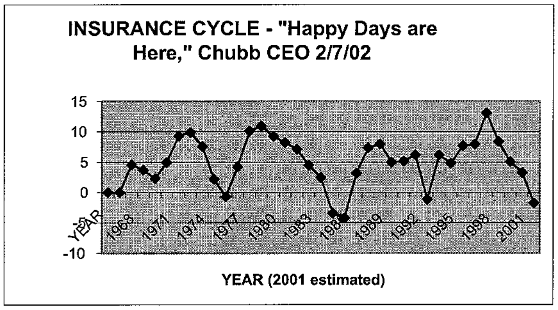
[3] Closing price as of February 15, 2002.

Over the last year, CFA's research revealed that average prices rose by about 20% for small businesses, 30% for mid-sized businesses, and 40% for large businesses. But the averages hide very high jumps in prices for some specific businesses. The worst hit are large, "terrorist target" risks, such as skyscrapers.

Some large businesses also are having difficulty getting sufficient terrorism insurance in amounts similar to the levels of previous years. Homeowner and car owner insurance appears to be fully available with only modest price increases forecast for 2002 (in the four to six percent range). Terrorism coverage for smaller commercial accounts has been excluded for many risks if insured losses from a terrorist attack exceed $25 million. However, the coverage can be bought back at a price that is manageable for most small businesses.

There appears to be little if any problem with loans in the current market for terrorism insurance. No federal bank regulator has issued any guidance on the terrorism insurance issue since they have not seen solvency problems developing from any real or perceived lack of coverage. Indeed, banks are acting as insurers of terrorism by taking risks with no terrorism coverage onto their books and charging a slightly higher interest rate in consideration of the increased risk.

The price jumps we are seeing is consistent with a classic cycle turn, accelerated by the events of September 11th but not caused by them. The chart below shows the operating income as a percentage of premium from 1967 to 2001. The operating income of the industry falls below zero four times on the chart – in 1975, in 1984 and 1985, in 1992, and in 2001 (the last number estimated by CFA).



The price increases in the hard market caused by this cycle turn began in late 2000. The rate of change was accelerating upward before September 11th. The terrorist attacks sped up the price increases into what some seasoned industry analysts see as gouging. Insurance executives have greeted the end of the hard market warmly. Mr. Dean R. O'Hare, Chubb chairman and chief executive said, "Happy days are here," at Chubb's February 7, 2002 conference for market analysts.[4]

CFA does not anticipate that the current hard market will last long. The capital inflow exceeds the terrorism loss, leaving the industry overcapitalized.

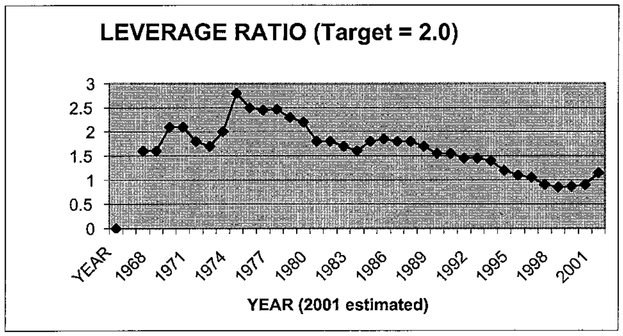
The larger firms with the most problems in price and coverage availability have alternatives to traditional terrorism insurance such as self-insurance, "layering" (i.e., buying many small insurance contracts to replace one large one), creation of captive insurance companies and even securitizing the risk.

Insurance is largely available, even to the highest risks. Reuters reported that "Commercial insurance is available to airlines, but at huge cost. A source at a major international insurance broker said $1 billion of liability cover for war and terrorism would cost about $3.10 cents per passenger."[5]

CFA has found no broad economic problems caused by the terrorism insurance situation. For instance, Standard & Poor's believes that "The ratings implications for corporates are likely

[4] "Chubb Makes Happy Forecast After A Drop," Daniel Hays, National Underwriter Online News Service, February 7, 2002.
[5] "UK Extends Airline War Insurance For Last Time," Reuters, January 21, 2002.

to be very limited and selective."[6] Even in New York, the epicenter of the terrorist attack, the economy appears to be improving, according to the Federal Reserve Board.[7]



The above chart shows the financial strength of the industry. A "leverage ratio" is the ratio of net premiums written (i.e., after reinsurance) to the surplus; the amount of money the insurer has to back-up the business (assets less the liabilities). Surplus differs from reserves, which are liabilities set up to cover claims. The leverage ratio has always been the key measure of insurer strength.

The rule of thumb used for decades by insurance regulators and other experts in determining solidity is the so-called "Kenny[8] Rule" of $2 of premium for each $1 of surplus as safe and efficient use of capital. Some now say that this rule is antiquated, given the new level of catastrophe possible, but new ways of spreading the risk, such as securitizing it, may offset this. CFA still believes a 2:1 ratio is safe. But even those proposing a lower ratio do not suggest ratios below 1.5:1. The NAIC uses a 3:1 ratio as the standard for determining if an individual insurer warrants solvency inspection. The chart shows that current and recent ratios fall well within these measures of safety.

[6] "S&P: Insurers to Cut Cover for Losses Due to Terror," S&P Business Wire, January 9, 2002.
[7] "Fed Economic Outlook," Associated Press, January 15, 2002.
[8] Named after a famous insurance financial writer, Roger Kenny.

Market Conditions Since Release of the CFA Study

CFA has continued to review the market since our initial report was finished in late January. The conclusions continue to hold in late February. We realize that there are some limited problems, but nothing requiring broad, immediate federal action.

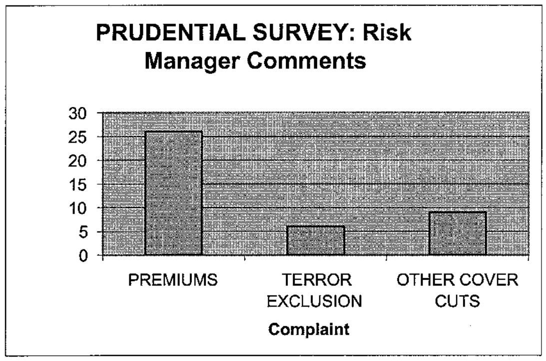
For confirmation of this, consider a recent Prudential Financial survey.[9] The key findings of the Prudential survey of 120 major commercial businesses' risk managers were:

- Individual programs are going through an extensive re-underwriting process. Most risk managers surveyed said that insurers are asking more questions and the renewal process is taking much longer to complete than in previous years.
- Average price change statistics are meaningless. Rate changes vary considerably by program.
- 68 percent of risk managers surveyed reported tighter terms and conditions in recent renewals; 79 percent who have not renewed expect tighter terms and conditions.
- Business is moving to new carriers but not for a lower price. A larger number of programs are changing underwriters with the most frequently cited reason being less stringent terms.
- Brokers are not suffering unduly from the effects of the hard market—broker services are still in demand.

In its survey, Prudential Financial found that 70 percent of the participants who had renewed their insurance noted an average premium increase of 18 percent.

Prudential reported comments of the risk managers who offered such thoughts. The comments show that lack of terrorism coverage is not a major concern compared to prices and even to other coverage cutbacks such as increased retentions (see chart below). The concerns are consistent with a normal hard market. The reason most often given for the price rises by the risk managers was opportunistic pricing by the insurance companies.

[9] "2002 Insurance Buyers' Survey," Prudential Financial, January 25, 2002.



<u>What Congress Should Do to Help Consumers, Businesses and Insurers</u>

As I said, CFA supported the House terrorism insurance approach (H.R. 3210) that passed the Financial Services Committee.[10] CFA commends the committee members for their work on the bill, particularly Chair Oxley, Subcommittee Chair Baker and Ranking Member LaFalce.

CFA testified that, while we were unsure what would happen if Congress did not act to provide back-up for terror coverage, we thought that the potential consequences were "...severe enough that Congress should worry..."[11]

However, after January 1st of this year, when 70 percent of reinsurance contracts came up for renewal, the "sky did not fall," contrary to some of the predictions that were made. The private sector seems to be adjusting to the reality of the hard market and limited unavailability of terrorism coverage.

Given the actual situation, here is what CFA recommends that Congress do now:

[10] CFA opposed the version of H.R. 3210 that passed the full House because of draconian liability restrictions that were added on the Floor.
[11] Testimony of CFA Director of Insurance J. Robert Hunter, Senate Commerce Committee Hearing, October 24, 2001.

A. Don't Rush Into Passing a Back-Up Bill

Congress has ordered the General Accounting Office (GAO) to review the insurance market and determine if there is a problem. This is an excellent first step.

It would be a good idea to hold hearings, not only to examine market conditions, but also to look into private alternatives to federal back-up.

If a terrorist event occurs again there will be terrorism insurance in place on the vast majority of risks. That is now clear. Even the Olympics, surely a prime target, secured coverage.[12] Stand-alone terrorism coverage is "easy to obtain for good risks."[13] Terrorism reinsurance is available on a facultative basis, but getting it on a treaty basis is harder.[14] "Greater leniency on terrorism cover in particular seems to have won the (reinsurance) start-ups market share at the expense of other markets, especially Lloyd's," says a report issued by the London-based reinsurance intermediary, Benfield.[15] Even target risks such as new construction projects can usually get it.[16] And large reinsurers are contemplating setting up a separate company to write terror risks.[17] Insurers are developing ways to rate terror coverage, including developing new computer models for that purpose.[18]

Even some of those risks not securing "normal" insurance have found ways to effectively cover the risk of terrorism. Some are using the Liability Risk Retention Act to cover the liability part of the terrorism risk. Terrorism and even war liability are being covered by airlines, through a risk retention group formed in Vermont.[19] Captives are forming to cover terrorism, for instance for construction trades.[20] And banks are freely loaning money, often at somewhat higher rates so they are bearing some of the risk in that way.[21]

Thus, inaction by the Congress, which CFA thought was a mistake last year, has had a very positive result – it has fostered private sector innovation.

Are there problems in the market? Sure. But they are being resolved. And Congress can always act after an event, even quickly, as you did with the airline bailout bill. We urge

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12 "Insurers Learn from Federal Inaction on Requests for Terror Aid," BestWire, February 20, 2002.
13 "Terror Coverage Market Grows," Business Insurance, February 18, 2002.
14 "Insurers Scramble for Cover," National Underwriter, February 18, 2002.
15 "Pricing Competition Returns to Reinsurance Market," National Underwriter, February 18, 2002.
16 "Terror Risk hits new Construction," Business Insurance, February 18, 2002.
17 "Big Europe firms discuss terror insurer scheme," Reuters, Feb 21, 2002
18 "Cat Modeling for Human Disasters," National Underwriter, February 13, 2002.
19 "U.S. airlines have plan to cover war liability risks," Reuters, February 11, 2002.
20 "D.C. Grants Second Captive License," National Underwriter, Jan. 31, 2002.
21 "Bankers Plugging Terrorism Insurance Gap," National Underwriter, Feb. 11, 2002.

Congress to go slow and allow these private sector alternatives to develop. Indeed, as I suggest below, you should consider ways to encourage such developments.

B. No Handouts are Warranted

If one thing is clear, it is that Congress should not do a taxpayer-funded bailout of this well-capitalized industry. If any federal back-up is required, it should be a loan program modeled after the House bill, not a hand out that does not require assistance to be paid back.

C. Create Incentives for the Development Of Private Sector Alternatives

Instead of spending time working on what appears likely to be an unnecessary taxpayer back-up of the insurance companies, Congress should provide incentives for the creation of the fast-developing private alternatives to the over-priced insurance in today's market. Consideration should be given to such ideas as:

- Expanding the Liability Risk Retention Act to cover property insurance.
- Determining if there are any tax disincentives for the development of captive insurance or self-insurance mechanisms.
- Developing proposals to encourage the securitization of risk.

Congress has created incentives for private sector alternatives before, with the Risk Retention Act (RRA). The Product Liability Risk Retention Act of 1981 was developed by Congress as a direct result of the product liability insurance hard market of the mid-1979s. The current version of the Act, the Liability Risk Retention Act of 1986,[22] was passed to expand the Act to all commercial liability coverages as a direct reaction to the hard market of the mid-1980s. It allowed businesses to join together to form purchasing groups to buy liability insurance as a unit or to form self-insurance combinations by getting approved in only one state. The airlines are already using the act to create a private solution for terrorism coverages for liability. They should be able to cover their property (hulls) in a similar manner.

[22] 15 USC §3901 et sec.

If the airlines, surely a target, can find private solutions, the NFL and other large commercial businesses with the ability to spread risk could take this approach, rather than seeking a taxpayer-backed handout[23].

The NAIC describes the RRA as follows:

> The purpose of the RRA is to increase the availability of commercial liability insurance which became severely restricted in the market crisis of the mid-1980s...An RRG[24] is a risk-bearing entity that must be chartered and licensed as an insurance company in one state...Once the group has obtained a license, it may operate in all states...and is regulated almost exclusively by the domiciliary commissioner...The RRA requires that the RRG be owned by its insureds and requires the insureds to have similar or related liability exposure. The only type of coverage an RRG is permitted to write is commercial liability insurance for its members and reinsurance with respect to the liability of any other RRG...A PG[25] may purchase only commercial liability insurance for its members...[26]

CFA believes that the creation and expansion of the RRA helped to overcome the problems of the two previous hard markets and would do so again in the current hard market. Not only would expansion of the Act enable small- and mid-sized businesses to get together to cover other risks, the alternative puts pressure on the insurance industry to stop the price gouging now underway or risk losing market share.

CFA calls on Congress to expand the RRA to cover all lines of property/casualty insurance, including property and workers' compensation. Consideration should be given to expanding the Act to cover group life and group health contracts, since many businesses getting together would eliminate the aggregation problem in these lines of insurance.

Finally, the hearings on expanding the RRA should also consider the creation of a personal lines version of the Act because, even though the terrorist problem is not severe in

[23] The NFL has 32 stadiums across the nation as well as other properties. Further, there are many other professional arenas (not to mention college and school facilities) that could be included in a RRG to cover terrorism insurance.
[24] RRG is a Risk Retention Group operating under the RRA, the Risk Retention Act.
[25] PG is a Purchasing Group.
[26] Risk Retention and Purchasing Group Handbook, NAIC, 1999, Pages I1-13.

personal lines, there are obstacles to the use of efficient group sales of home and auto insurance that RRA would overcome.

D. Address Rate Gouging in any Bill that Passes

If a back-up bill is considered, the bill must adequately address the problem of the price of insurance. It would be foolish to pass a back-up bill and not assure that insurance rates are rolled back to reflect the reduced level of insurer risk that would occur from the creation of the federal back-up.

Hearings held on terror insurance legislation should include consideration of:

- Requiring rate reductions equivalent to the amount of back-up provided. For example, if terrorism coverage is 10% of the rate increase, and the taxpayer is backing up 90% of that subject to later pay back, the premium increase should be rolled back by 9%.
- Requiring states to certify that rates are not excessive. Certainly, any bill that is considered should not prohibit pre-approval of rates, as one Senate draft contemplated.
- Requiring a terror insurance line item on the bill. It is very important that businesses can see the price differences for terrorism and other coverages. This would allow business to determine if other coverages are being unduly hiked vis-à-vis the businesses' claims experience.

What the States Should Do

The CFA report made several recommendations to the states, including:

A. Reject Exclusions for Personal Lines of Coverage

The states adopted this recommendation.

B. Reject Exclusions for Commercial Lines for Small and Mid Sized Insureds

Many states allow exclusions, even for small business. CFA has asked the states to revisit this decision since small business should be treated in the same way as personal lines.

C. Require the Cost of Terror Insurance Coverage as a Line Item on The Bill

The states could do this now under their current authority. (See discussion under federal proposals, above.)

D. Review Pricing in the Marketplace, to Prevent Price Gouging, Particularly for the Non-Terror Part of Rates for Smaller and Mid Sized Commercial Insureds.

The actuarial considerations are well known for these coverages. There is no reason why the states should not step into the current non-competitive market and assure the business insurance consumers of their states that the rates meet the "not excessive" requirements of state statute. The states should undertake rigorous analyses of ratemaking methods and rate filings and make sure such an analysis is available to the public.

E. Reject the Model Commercial Lines Deregulation Bill Now Before the NAIC for Approval in March, or at Least Delay it Until Price Gouging is Not Present in the Market.

The states need to assure the buyers of business insurance that they are doing their job to protect them. Certainly, with price gouging occurring in the market even for large risks, now is not the time to be deregulating commercial lines. The NAIC should table or reject this Model Bill.

Madame Chair, I will be happy to respond to questions at the appropriate time.

Consumer Federation of America

How the Lack of Federal Back Up for Terrorism Insurance Has Affected Insurers and Consumers:

An Analysis of Market Conditions and Policy Implications

A Report by the Consumer Federation of America

January 23, 2002

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I. Introduction

In the wake of the terrorist attacks of September 11, 2001, many concerns were raised about the impact of this unprecedented and tragic event on insurers and insurance consumers, including businesses. Insurance industry losses from the attacks were estimated to be as high as $70 billion. Approximately 70 percent of all reinsurance contracts were due to expire at the end of the year, making it virtually impossible for primary insurers to get back up for future terrorism losses. Without this reinsurance, there was great fear about what would happen to the price and availability of insurance—and to the economy as a whole--if Congress didn't provide federal terror insurance back up. There was broad consensus among interest groups (including consumer organizations) and lawmakers of both parties that federal assistance was necessary, but disagreement about how to provide it. Ultimately, Congress adjourned in December without enacting terrorism insurance legislation.

The purpose of this report is to evaluate the effect of the terrorist attacks—and the lack of federal back up—on insurance rates and availability, and on the financial condition of the insurance industry. The report also outlines new policy options that the states and Congress should consider to guarantee affordable terrorism coverage to individual and business consumers.

II. Status of the Insurance Market Today

A. Losses from the World Trade Center Attack Will be Less Than Anticipated

Insurance losses stemming from the World Trade Center attacks will be far less than first anticipated, according to New York State Insurance Superintendent Greg Serio. He told the New York State Senate Insurance Committee on January 14, 2002 that total payouts should reach $35 billion before the effects of taxes, far less than the $70 billion projected by the industry and the $60 billion first anticipated by his Department.[1]

This is the largest single insured loss in history in dollar terms. The previous record was Hurricane Andrew, which hit Florida and the Gulf Coast in 1992, causing $16 billion in pre-tax insured losses.

The projected after tax impact of the September 11 events is a loss of $23 billion.[2] Hurricane Andrew's post-tax hit on the insurance companies was $10 billion.[3]

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[1] New York Post, January 15, 2002. The new projections are due to a lower death count and not as many business losses as expected.
[2] $35 billion in pre-tax losses less the 35% corporate tax write-off applicable to claims.
[3] $16 billion in pre-tax losses less the 35% corporate tax write-off applicable to claims.

The impact on the bottom line of the insurance industry from the September 11 terrorist attack was 7.2% of surplus as of the beginning of 2001.[4] The impact on the bottom line of the insurance industry from the 1992 Hurricane Andrew event was not much less: 6.3% of surplus as of the beginning of 2001.[5]

B. The Insurance Industry is in a Very Strong Financial Position After the Terrorist Attacks

Many analysts are predicting that 2002 could be a very profitable year for the insurance industry.[6] [7] [8] In the first ten weeks after the terrorist attack, the insurance industry saw a surge in capital of $24.4 billion, according to Morgan Stanley.[9]

Thus, a key CFA finding is that the insurance industry is now better capitalized than before September 1, 2001. The capital lost by September 11th was about $23 billion and the new capital already booked by the industry is over $24 billion.

To be sure, the "lost" capital and the "new" capital are not necessarily in the same insurance companies, but the industry as a whole is more strongly capitalized now than when the terrorists struck – surely a victory for capitalism over terrorism.

Anticipating high returns in a hard market, some of this capital has flowed to new offshore reinsurance companies.[10] A number of new companies, most of which were created by existing industry leaders,[11] have been capitalized with as much as $9 billion.[12] [13]

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[4] $23 billion in post-tax loss divided by the starting surplus of $321.4 billion (per 2001 Edition of Best's Aggregates and Averages).

[5] $10 billion in post-tax loss divided by the starting surplus of $158.7 billion (per 2001 Edition of Best's Aggregates and Averages).

[6] "The expected rise in rates and tightening of coverage terms and conditions will boost industry profitability this year, the respondents [industry leaders who were surveyed] added.... Ninety percent predicted higher profits in commercial lines (excluding workers' compensation, for which only 65 percent expect better results). "Analysts: Hard Market Might Be Short-Lived." National Underwriter Online News Service, January 16, 2002.

[7] "Despite an expected $50 billion plus in claims stemming from the World Trade Center collapse, not to mention damage from lat year's heavy flooding and storms, the insurance industry is poised to do quite well. The September 11 attacks stimulated demand for property and casualty insurance and provided a rationale for a new round of hefty premium boosts. Moreover, insurers are limiting their losses to terrorism by raising deductibles or excluding some coverage, if state regulators say OK. Life insurers, too, report higher sales as people reassess family responsibilities. Also climbing are rates for auto and homeowner coverage. Premium hikes across the industry will be outpacing the growth in claims...Another sign of strength: the formation of new firms, including a joint venture by powerhouses AIG, Chubb, and Goldman Sachs." "Insurance: Surprising Survival in a Risky Business," U.S. News and World Report, January 14, 2002.

[8] "Soaring premium volume, tighter underwriting, an influx of capital, a recovering economy, and a rising stock market will combine to make 2001 an anomaly. Absent more terrorist attacks or major natural disasters, industry results will improve dramatically next year." "Top 10 Stories of 2001," National Underwriter, December 24/31, 2001.

[9] "'The capital markets raised $24 billion in 10 weeks, which is breathtaking,' said Alice Schroeder, managing director of Morgan Stanley in New York. 'In addition, many companies that were hit hard [by terrorist attack claims] on 9/11 entered the 1/1 renewal season with at least as much, if not more capital than they had on 9/10. There's plenty of capacity out there.'" National Underwriter Online News Service, January 16, 2002.

[10] "New entrants could grab up to $6.5 billion in reinsurance premium this year, out of a total estimated volume of $110 billion, Standard & Poor's predicts." Professional Insurance Agents Association Web Site, January 16, 2002.

The new capital, the prospect of increased demand for property-casualty insurance and lucrative premium increases has strengthened the position of the largest insurance companies on Wall Street. The average stock price for the seven largest insurers has increased by 2.6% since the closing stock price of September 10th, an annual rate of 7.8% (see Appendix A).

C. There are Manageable Problems in Insurance in The Wake of September 11th

1. The Biggest Concern is High Commercial Insurance Rates

According to data released by the Council of Insurance Agents (CCIA) and Brokers,[14] commercial premiums are increasing quickly. According to estimates made by CFA based upon the CCIA data for the 12-month period ending December 31, 2001, average prices rose as follows:

Small Commercial Accounts	+21%
Mid-size Commercial Accounts	+32%
Large Commercial Accounts	+36%

The worst hit are "terrorist target" risks, such as skyscrapers. According to the CCIA survey, CFA calculates the average increases over the last year by line of insurance as:

Business Interruption	+30%
Construction	+46%
Commercial Cars	+28%
Property	+47%
General Liability	+27%
Umbrella Liability	+56%
Workers' Compensation	+24%

Interestingly, the broad rate increases are occurring even when terrorism is excluded. The market shows all the earmarks of a classic cycle bottom, which is discussed in some detail below.

The price for terrorism coverage is very high and coverage appears to be limited, requiring higher self-insured retentions (deductibles) and lower aggregate limits.

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[11] "Almost all of them [new reinsurance companies] are vehicles created by some of the industry's biggest insurance companies and brokers, including AIG, Aon, Marsh, State Farm, Zurich and others of similar size." "Report Reinsurance Rate Rise Reduced," Reuters, January 14, 2002.

[12] "The companies are among eight insurers and reinsurers that have formed in Bermuda since the Sept. 11 terrorist attacks in the United States. The startups so far have raised more than $9 billion in capital." "Two More Reinsurers Form in Bermuda," Business Insurance Daily News, January 21, 2002.

[13] "Much of the new capital went to Bermuda, where at least six new insurers have been capitalized with a total of more than $6 billion. At least another $3.37 billion was raised by existing facilities." "Year in Review," Business Insurance, December 24, 2001.

[14] 4th Quarter 2001 Survey, released January 2002.

2. Some Large Commercial Insureds are Having Difficulty Getting Sufficient Terrorism Coverage from the Normal Insurance Market

Besides the high rate problem, there appears to be difficulty for very large commercial risks in getting terrorism coverage in amounts similar to the levels enjoyed in previous years.

The individual risk (homeowner and car owner) appears to be able to get full coverage with only modest price increases forecast for 2002 (in the 4 to 6% range). These modest increases highlight the lack of impact that the terrorist attacks had on personal lines of insurance. Nonetheless, insurers have petitioned the National Association of Insurance Commissioners to allow them to exclude terror coverage for personal lines of insurance. CFA has urged the NAIC to disapprove this request.

Consistent with a classic cycle turn, small commercial accounts are seeing much higher increases (in the 15% to 25% range). Terrorism coverage for smaller commercial accounts has been excluded if insured losses from a terrorist attack exceed $25 million. The coverage can be bought back at a price that is manageable for most small businesses.

Mid-size businesses are also seeing high price increases (in the 25% to 35% range, also with the terrorism cover excluded. The cover can be frequently be bought back at a price that is manageable.

Very large risks are seeing the largest price rises (+30% to + 40%) and having the hardest time finding the usual terrorism insurance coverage. It should be noted, however, that even some of the businesses that are most at risk of future terrorist acts—such as airlines--have been able to procure liability insurance coverage.[15]

Fortunately, these large and sophisticated accounts have a wide array of alternatives to normal insurance, including self-insurance, layering of coverage through the use of many insurance companies, use of captive insurance companies, the non-standard, off-shore market and even risk securitization. We discuss these options in more detail later in this report.

3. Commercial Insureds Generally Appear to be Getting Loans Without Terrorism Coverage

According to an article in the January 7, 2002 edition of American Banker, there is little if any problem with loans in the current market for terrorism insurance. No federal bank regulator has issued any guidance on the terrorism insurance issue since they have seen no solvency problems developing from any real or perceived lack of coverage.[16]

[15] "A source at a major international insurance broker said $1billion of liability cover for war and terrorism would cost about $3.10 per passenger." "UK Extends Airline War Insurance For Last Time," Reuters, January 21, 2002.
[16] "'We haven't discussed putting out any guidance, either internally or with other regulators,' said David D. Gibbons, the deputy comptroller for credit risk at the Office of the Comptroller of the currency. 'We would need to see some evidence that this issue has impacted credit availability. We have not seen that. No one has come to us and said this is curtailing lending.'" "No Terror Insurance, But Lenders Still Lending," American Banker, January 7, 2002.

Banks seem to be treating it, according to the article, as just another factor to consider in making loans. For example, the article states, "'We have to factor it into our risk on a case-by-case basis, but insurance is just one of many factors we take into consideration,' said William L. Perotti, the group executive vice president and chief credit officer at Frost National Bank in San Antonio... 'I'd hate to see us deny credit to a creditworthy borrower just because their insurance didn't cover acts of terrorism. You just can't do that.'"

Banks have made it very clear that, contrary to predictions made by some insurers, they will not be calling any loans because of the loss of terrorism coverage by a mortgagee.[17] [18]

D. This is a Classic "Hard" Cycle--with Prices Rising--Accelerated by the Events of September 11th

Insurance is a cyclical business. This is particularly true in the commercial insurance business.

In the mid-1970s, the country experienced the first liability insurance crisis. In this case, the crisis was particularly acute in product liability insurance and medical malpractice insurance.

At the mid-70s cycle low, the industry's rate of return was "2.6% in 1975," rose "to 19.7% in 1977, a gain of almost 17 points in the course of only two years. The industry's rate of return then fell by more than 17 points over the next 7 years to 1.9% in 1984, the nadir of that soft market. During the subsequent hard market, profits once again shot up…to 15.4%" (by 1987).[19]

The mid-1980s crisis was in commercial liability generally, hitting municipalities, day care centers, environmental liability and many other liability risks and lines. *Time* magazine had a cover story called "Sorry America, Your Coverage is Cancelled."

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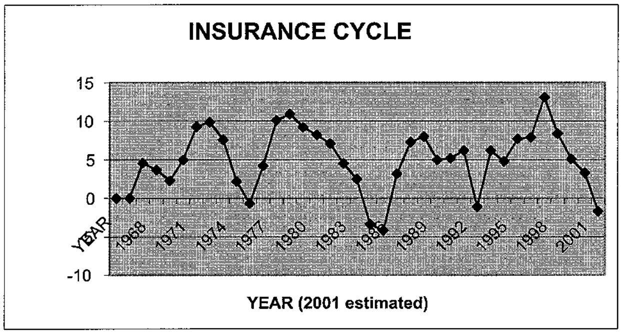
17 "As it lobbied for a terrorism-insurance bill, the industry told lawmakers that a lack of affordable coverage would hurt a hoped-for economic recovery, as banks would be unwilling to make loans to projects not backed by full insurance coverage. While the insurance is more readily available than predicted, the jury is still out as to how the high prices will affect policyholders. One positive sign: According to insurance brokers, banks aren't pulling their financing for clients who lack the coverage, as had been by some proponents of the federal insurance program. Instead, they are charging higher fees for some customers who are going without terrorism coverage." Wall Street Journal, January 4, 2002.

18 "As legislation to establish a federal reinsurance program stalled over politics, many warned that bankers might start calling in loans for existing projects. … However, all of the lenders interviewed for this article were unanimous in saying they will not call in loans for existing projects that lost terrorism coverage on Jan. 1. 'We have a half-dozen deals where we are requiring terrorism insurance,' said Fleet Boston's Mr. [John] Mastomarino. 'They'll get it. It'll cost them more. But in our opinion it will not be so prohibitive as to hurt the economics of the deal that much. When you're talking about big projects, on a percentage basis of the overall cost it is quite small.'" "No Terror Insurance, But Lenders Still Lending," American Banker, January 7, 2002.

19 Cycles and Crises in Property/Casualty Insurance: Causes and Implications, edited by Cummings, Harrington and Klein, NAIC, 1991. Page 11.

Two charts below show the cyclical nature of insurance.[20] The first chart, "Insurance Cycle" shows the operating income as a percentage of premium from 1967 to 2001. The operating income of the industry falls below zero four times on the chart – in 1975, in 1984 and 1985, in 1992, and in 2001 (the last number estimated by CFA).



The 1992 data point was not a classic cycle bottom, but reflected the impact of Hurricane Andrew and other catastrophes in that year.

The 1975 and mid-80s bottoms were both classic cycle bottoms with very sizeable price increases and coverage availability problems immediately following the bottom. Consider the mid-80s cycle turn: between 1977 and 1984, insurance premiums had "...actually declined (by) 4.4%...From 1984 to 1987, net premiums written increased 63.3%..."[21]

The price increases in this cycle turn began in late 2000.[22] The rate of change was accelerating upward before September 11th. The terrorist attacks sped up the price increases into what some seasoned industry analysts see as gouging.[23] Many examples of unjustified price increases have surfaced in the last few months.[24] [25]

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[20] Both of these charts use data from A. M. Best and Co., Aggregates and Averages, 2001 edition for all years except 2001, where CFA made estimates of the results based on current information.

[21] Cycles and Crises in Property/Casualty Insurance: Causes and Implications, edited by Cummings, Harrington and Klein, NAIC, 1991. Page 8.

[22] "The Big Question For 2002: Will Hard Market Last Long?" By Sean F. Mooney, National Underwriter, January 7, 2002 edition.

[23] "...there is clearly an opportunity now for companies to price gouge – and it's happening...But I think companies are overreacting, because they see a window in which they can do it." Jeanne Hollister, consulting actuary, Tillinghast-Towers Perrin, in, "Avoid Price Gouging, Consultant Warns," National Underwriter, January 14, 2002.

[24] "As Insurers Hike Prices, State Regulators Consider Reducing Regulatory Authority," Consumer Federation of America, December 5, 2001.

[25] "We've seen premiums go up as much as 40-70 percent," says [Jenny] Jones [CEO of Elkins/Jones insurance brokerage]. She points out that commercial buildings which now pay five or six cents per square foot for insurance need to budget for costs to go up to as much as seven or eight cents a foot. She says the increases could be across

Gouging usually does occur as the cycle turns.[26] The evidence is very strong that what we are experiencing is a classic underwriting cycle turn into a "hard," from a prolonged "soft," market.

According to the National Association of Insurance Commissioners, "...underwriting cycles may be caused by some or all of the following factors:

1. Adverse loss shocks...unusually large loss shock...may lead to supracompetitive prices.
2. Changes in interest rates...
3. Under pricing in soft markets..."[27]

Prior to September 11th, the industry had been in a soft market since the late 1980s. The usual six to ten year economic cycle had been expanded by the amazing stock market of the 1990s. No matter how much they cut their rates, the insurers wound up with a great year when investing the float on the premium in this amazing market (the "float" occurs during the time between when premiums are paid into the insurer and losses paid out by the insurer – e.g., there is about a 15 month lag in auto insurance). Further, interest rates were relatively high in recent years as the Fed focused on inflation.

But, in the last two years, the market turned with a vengeance and the Fed cut interest rates again and again. Item 2 above had occurred well before September 11th.

Item 3 above, the low rates, were also apparent. The chart, "Insurance Cycle," shows the operating profit drop from about 13% of premium in 1997 to about 3.5% of premium in 2000.

So, before September 11th, the cycle had turned, rates were rising and a hard market was developing. An anticipated price jump of 10% to 15% in 2001 was predicted by CFA and confirmed by the Insurance Information Institute.

Item 1, the shock loss was all that was missing. September 11th provided that in an achingly painful way.

However, the increases are mostly due to the cycle turn. The price increases were sped up by the terrorist attack, collapsing two years of anticipated increases into a few months, but the bulk of the increases are not related to pricing for terrorism, per se. This is a classic economic cycle.

The question we hear a lot of debate about is how long the hard market can last. Given the amazing inflow of capital, can the prices hold for long?

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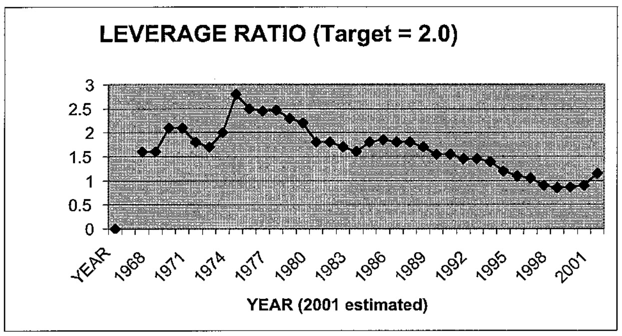
the board for all types of properties. Single family housing developers could be sharply affected, she notes, citing one homebuilder whose liability premium doubled at the November 11 renewal." "Large Insurance Premium Increases in 2002 as September 11 Ricochets Through Industry, Expert Advises," Business Wire, January 3, 2002.

26 "To be sure, the market began firming in 2000. But the Sept. 11 terrorist attacks sent insurance prices skyrocketing far beyond the estimates of increases that earlier were being attributed to a normal hard cycle." "Year in Review," Business Insurance, December 24, 2001.

27 Cycles and Crises in Property/Casualty Insurance: Causes and Implications, edited by Cummings, Harrington and Klein, NAIC, 1991. Page 339.

While the jury is still out on that question, there are some factors that make it seem likely that the hard market will be brief. They include:

- The capital inflow in excess of the after-tax terrorism loss,
- The relatively overcapitalized position of the industry as shown in the chart, "Leverage Ratio," below,
- The availability of alternative risk mechanisms to the larger client risks, the insureds with the biggest price hikes,
- The pattern of risk managers blaming insurers, not the terrorism event, for renewal problems, and shopping for better deals.[28]



A "leverage ratio" is the ratio of net premiums written (i.e., after reinsurance) to the surplus, the amount of money the insurer has to back up the business; assets less the liabilities. Surplus is not reserves, which are liabilities set up to cover claims. The leverage ratio has always been the key measure of insurer strength.

The rule of thumb used for decades by insurance regulators and other experts in determining solidity is the so-called "Kenny[29] Rule" of $2 of premium for each $1 of surplus as safe and efficient use of capital. Some now say that this rule is antiquated, given the new level of catastrophe possible, but new ways of spreading the risk, such as securitizing it, may offset this. CFA still believes a 2:1 ratio is safe. But even those proposing a lower ratio do not go below 1.5:1. The NAIC uses a 3:1 ratio as the standard for determining if an individual insurer warrants solvency inspection.

When the cycle turned in the mid-70s, the premium/surplus ratio was as high as 2.8 to 1. This was a dangerously high average ratio since many insurers exceeded the 3:1 NAIC problem ratio. When the mid-80s cycle turned, the ratio was as high as 1.8 to 1 – a relatively safe level.

[28] "Risk Managers Blame Insurers for Renewal Woes," National Underwriter, January 14, 2002
[29] Named after a famous insurance financial writer, Roger Kenny.

In today's cycle turn, CFA projects the ratio for 2001 year-end to be about 1.2 to 1, extremely safe and, indeed, overcapitalized.

E. Larger Firms – the Locus of the Current Insurance Problems – Have Many Alternatives to Traditional Terror Insurance Coverage

Many high risks are adapting to the current market by using a variety of alternatives available to them[30 31], such as:

1. Self-insurance – under this method, a large risk simply self-insures more of the risk than heretofore. This can take many forms including: larger retention or deductible, taking layers of the risk above some insured portions, taking lower coverage limits, etc. This is not "going bare" since a plan is in place to reserve for or otherwise cover the potential losses.

2. "Layering" – Under this approach, the large account buys many small insurance contracts to replace one large one if large amounts of insurance are not available. Insurance brokers are expert at finding ways to layer together a package, which replicates coverage of the previous year's size.[32]

3. Captives – here the large risk, alone or with other similar businesses, creates an insurance company to write the risk. These companies are often offshore, but a few states have captive programs (e.g., Vermont.)

4. Securitizing risk – In the wake of Hurricane Andrew, several insurance companies obtained a new form of protection against risk: the securitization of risk by means of Act of God Bonds and other financial instruments. This is a very attractive option for terrorism risk as well, since financial markets have huge assets and are able to withstand price swings that make insurance catastrophes seem tiny by comparison.

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[30] "The German chemicals group BASF said on Wednesday that it was talking to other blue-chip firms about setting up their own reinsurance company to provide protection against terror risks no longer covered by reinsurers. "BASF Mulls Own Reinsurance with Other Companies," Reuters, January 16, 2002.

[31] "As opposed to prior hard markets, businesses in 2002 have a lot more options to manage exposures than through the pure transfer of risk by insurance. In considering these options, businesses need to assess when the current upturn in pricing will peak, and when pricing will return to rates that clients consider acceptable. ... The use of alternative risk-transfer vehicles is well developed. As insurers see that their customers are walking away, self-insuring rather than paying directly for risk transfer, they might be more inclined to decrease prices." "The Big Question For 2002: Will Hard Market Last Long" Sean F. Mooney, National Underwriter, January 7, 2002.

[32] "While underwriters, in many cases, are unwilling to provide the same limits they did a year ago, brokers have been able to fill gaps in coverage through layered programs. And, not surprisingly, they are seeing renewed interest among clients in alternative risk transfer options." "Brokers Pressed to Meet Coverage Needs," Business Insurance, January 14, 2002.

Eventually, many analysts expect insurers to find ways to cover the risk of terrorism under traditional property-casualty policies.[33] [34]

F. The Lack of Federal Terror Back-up Has Not Adversely Affected the Economy

Whatever problems are occurring for some companies with terror coverage, they do not appear to have caused broad economic consequences. For instance, consider the following Standard & Poor's position on rating businesses without terrorism insurance:

> "The ratings implications for corporates are likely to be very limited and selective," said Sol Samson, a managing director with Standard & Poor's Corporate Ratings group. "The additional risk may emanate from lack of coverage or much greater expense to obtain coverage. But the impact would be material only in situations where the perceived specific risk of a terrorist incident was high -- just as lack of earthquake insurance isn't a problem in regions that don't face much risk of such natural events." Furthermore, the impact would be diluted to the extent a company is diversified, i.e., operates many plants or facilities. In addition, even in cases that might be considered to carry serious terrorist attack potential, possessing insurance coverage could sometimes be irrelevant. "If cruise ships were perceived as targets, who would take cruises? If a landmark building were viewed as vulnerable to terrorist attacks, what rents could it command? Insurance cover for the boat or building wouldn't resolve the risk exposure," Samson added.[35]

Even in New York, the epicenter of the terrorist attack, the economy appears to be improving, according to the Federal Reserve Board:

> NEW YORK - Economic activity showed further signs of rebounding. Retailers said sales appeared to be gaining momentum in late December and early January. Business contacts said inventories were lean. Labor market exhibited signs of stabilizing. Unemployment insurance claims in New York City appeared to have retreated to levels seen before the Sept. 11 terror attacks. Housing market in most of district strengthened, except for Manhattan's rental market, which remained slack. Hotel occupancy rates continued to recover, but were down from a year earlier.[36]

CFA can find no widespread problems caused by the terrorism insurance situation in the United States as of January 19, 2002.

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[33] "Even if Congress stays on the sidelines, insurers—drawn by the promise of higher premiums and reassured by careful underwriting—will find terrorism exposures not nearly as intimidating as natural disaster risks, and will eventually write coverage for most clients at little if any additional charge." National Underwriter, December 24/31, 2001.

[34] Private markets for terrorism coverage might yet develop. Some savvy risk managers could come up with a private terrorism reinsurance pool. Or perhaps the major insurance brokerages will put a facility together. Also, we would not be surprised to see a 'Terrorism Re' in Bermuda sometime soon, following in the footsteps of those entrepreneurs who dared to write property-catastrophe coverage after Hurricane Andrew." National Underwriter, December 24/31, 2001.

[35] "S&P: Insurers to Cut Cover for Losses Due to Terror," S&P Business Wire, January 9, 2002.

[36] "Fed Economic Outlook", Associated Press, January 15, 2002.

G. Conclusion

CFA has come to five major conclusions about the current state of the insurance market, especially as it relates to terrorism coverage:

1. The insurance industry is wealthy and overcapitalized.
2. High rates are a problem for mid-size and larger insured firms.
3. The rate problem is caused by the classic turn in the economic cycle of the industry, sped up -- but not instigated --by the terrorist attacks.
4. Banks are freely loaning money to the vast majority of -- if not all — businesses, regardless of the terrorism insurance situation in the nation.
5. There are presently no widespread economic problems related to the terrorism insurance situation in America today.

These findings have important implications for Congress, which will be discussed in the second part of this report.

III. What Congress Should Do to Help Consumers, Businesses and Insurers

CFA supported the House terrorism insurance approach (H.R. 3210) that passed the Financial Services Committee[37]. CFA commended the committee members for their work on the bill, particularly Chair Oxley, Subcommittee Chair Baker and Ranking Member LaFalce.

CFA testified that, while we were unsure what would happen if Congress did not act to provide back-up for terror coverage, we thought that the potential consequences were "...severe enough that Congress should worry..."[38]

There is now some experience with the marketplace after January 1st of this year, when 70% of reinsurance contracts came up for renewal. Contrary to some of the predictions that were made about what would happen if federal backup was not in place, the "sky did not fall." The private sector seems to be adjusting to the reality of the hard market and some unavailability of terrorism coverage.

Here is what CFA recommends that Congress do now:

A. Don't Rush Into Passing a Back-Up Bill

Congress has ordered the General Accounting Office (GAO) to review the insurance market and determine if there is a problem. This is an excellent first step.

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[37] CFA opposed the version that passed the full House because of draconian liability restrictions that were added on the Floor.
[38] Testimony of CFA Director of Insurance J. Robert Hunter, at Senate Commerce Committee Hearing of October 24, 2001.

It would also be a good idea to hold hearings, not only to examine market conditions, but also to look into private alternatives to federal back-up.

B. No Handouts are Warranted

If one thing is clear, it is that Congress should not do a taxpayer-funded bailout of this super-rich industry. If any federal back-up is required, it should be a loan program modeled after the House bill, not a give away program that does not require assistance to be paid back.

C. Create Incentives for the Development Of Private Sector Alternatives

Instead of spending a lot of time working on what appears likely to be an unnecessary taxpayer back-up of the insurance companies, Congress should provide incentives for the creation of the fast-developing private alternatives to the over-priced insurance in today's market. Consideration should be given to such ideas as:

- Expanding the Liability Risk Retention Act to cover property insurance.
- Determining if there are any tax disincentives for the development of captive insurance or self-insurance mechanisms.
- Developing proposals to encourage the securitization of risk.

Congress has created incentives for private sector alternatives before, with the Risk Retention Act (RRA). The Product Liability Risk Retention Act of 1981 was developed by Congress as a direct result of the product liability insurance hard market of the mid-1979s. The current version of the Act, the Liability Risk Retention Act of 1986,[39] was passed to expand the Act to all commercial liability coverages as a direct reaction to the hard market of the mid-1980s. It allowed businesses to join together to form purchasing groups to buy liability insurance as a unit or to form self-insurance combinations by getting approved in only one state.

The NAIC describes the RRA as follows:

> The purpose of the RRA is to increase the availability of commercial liability insurance which became severely restricted in the market crisis of the mid-1980s...An RRG[40] is a risk-bearing entity that must be chartered and licensed as an insurance company in one state...Once the group has obtained a license, it may operate in all states...and is regulated almost exclusively by the domiciliary commissioner...The RRA requires that the RRG be owned by its insureds and requires the insureds to have similar or related liability exposure. The only type of coverage an RRG is permitted to write is commercial liability insurance for its members and reinsurance with respect to the liability of

[39] 15 USC §3901 et sec.

[40] RRG is a Risk Retention Group operating under the RRA, the Risk Retention Act.

> any other RRG…A PG[41] may purchase only commercial liability insurance for its members…[42]

CFA believes that the creation and expansion of the RRA helped to overcome the problems of the two previous hard markets and would do so again in the current hard market. Not only would expansion of the Act enable small and mid-sized businesses to get together to cover other risks, the alternative puts pressure on the insurance industry to stop price gouging now underway or risk market share.

CFA calls on Congress to expand the RRA to cover all lines of property/casualty insurance, including property and workers' compensation. Consideration should be given to expanding the Act to cover group life and group health contracts…since many businesses getting together would eliminate the aggregation problem in these lines of insurance.

Finally, the hearings on expanding the RRA should also consider the creation of a personal lines version of the Act because, even though the terrorist problem is not severe in personal lines, there are obstacles to the use of efficient group sales of home and auto insurance that RRA would overcome.

D. <u>Address Rate Gouging in any Bill that Passes</u>

If a back-up bill is considered, the bill must adequately address the problem of the price of insurance. It would be foolish to pass a back-up bill and not assure that insurance rates are rolled back to reflect the reduced level of insurer risk that would occur from the creation of the federal back-up.

Hearings held on terror insurance legislation should include consideration of:

- Requiring rate reductions equivalent to the amount of back-up provided. For example, if terrorism coverage is 10% of the rate increase, and the taxpayer is backing up 90% of that subject to later pay back, the premium increase should be rolled back by 9%.
- Requiring states to certify that rates are not excessive. Certainly, any bill that is considered should not prohibit pre-approval of rates, as one Senate draft contemplated.
- Requiring a terror insurance line item on the bill. It is very important that businesses can see the price differences for terrorism and other coverages. This would allow business to determine if other coverages are being unduly hiked vis-à-vis the businesses' claims experience.

IV. What the States Should Do to Help Consumers, Businesses and Insurers

A. <u>Reject Exclusions for Personal Lines of Coverage</u>

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[41] PG is a Purchasing Group.

[42] <u>Risk Retention and Purchasing Group Handbook</u>, NAIC, 1999, Pages I1-I3.

Personal lines were never seriously raised as a problem in the debate in Congress about terrorism legislation before January 1, 2002. This is because it is not a problem. There are millions of units of exposure with excellent spread of the risk throughout the nation. Moreover, it is unlikely that terrorists are going to target homes and cars in a way that would trigger an individual's umbrella coverage. At most, damage to homes would be "collateral damage" in an attack on a government building or large commercial facility should another terrorist event occur.

The insurance industry has acted in bad faith by failing to actively advocate for personal lines of coverage to be included in terrorism legislation, and then waiting until Congress adjourned before asking state regulators to allow them to exclude terror coverage from personal lines. CFA has asked the states not to approve terrorism exclusions for personal lines and, if they do, to explain to Congress why the states did not push for federal back-up for personal lines if there was a problem.

B. Reject Exclusions for Commercial Lines for Small and Mid Sized Insureds

For the same reasons as with personal lines, approximately 41 states should not have approved exclusions for terrorism for small and mid-sized businesses. Insurers can spread risk broadly and therefore should be able to make coverage available at reasonable prices. They should roll back these exclusions and limit them to very large commercial businesses, the likely targets of terrorism.

New York and California are to be applauded for disapproving the broad terrorism exclusions. Their refusal to allow exclusions to be applied generally in the commercial property-casualty market will not prevent insurers from removing terrorism coverage from the policies of large commercial companies, particularly "jumbo risks" that are possible terrorist targets. Insurance for these larger commercial risks are individually negotiated in what are known as 'manuscript' policies. CFA knows of no state law that mandates terror coverage for these individually crafted insurance policies.

As mentioned above, larger commercial risks also have methods other than traditional insurance to cover terrorism, such as self-insurance, the creation of captive insurers and the non-admitted market. These options are not generally available to smaller commercial risks, unless the RRA is so expanded as CFA has recommended.

C. Require the Cost of Terror Insurance Coverage as a Line Item on The Bill

(See discussion under federal proposals, above.) The states could do this now under their current authority, even without Congressional action.

D. Review Pricing in the Marketplace, to Prevent Price Gouging, Particularly for the Non-Terror Part of Rates for Smaller and Mid Sized Commercial Insureds

The actuarial considerations are well known for these coverages. There is no reason why the states should not step into the current non-competitive market and assure the business insurance consumers of their states that the rates meet the "not excessive" requirements of state statute. The states should undertake rigorous analyses of ratemaking methods and rate filings and make sure such an analysis is available to the public.

E. Reject the Model Commercial Lines Deregulation Bill Now Before the NAIC for Approval in March, or at Least Delay it Until Price Gouging is Not Present in the Market.

The states need to assure the buyers of business insurance that they are doing their job to protect them. Consider this account of the current market:

> "Paul Buckley, treasury director-risk management at Murray Hill, N.J.-based Lucent Technologies Inc., was furious with one of Lucent's former insurers.
>
> "The Hartford Specialty division of The Hartford Financial Services Group Inc. profited for five years while writing the unique basket aggregate reinsurance for Lucent's Vermont-based captive, First Beacon Insurance Co., Mr. Buckley said. The insurer had collected close to $1.8 million in premiums over the years it wrote the coverage and never came close to being hit with a loss, he noted.
>
> "But on Sept. 5, even before the terrorist attacks changed the insurance market landscape, Hartford sought a nearly fourfold premium increase. The hike was necessary because of the economic turmoil that telecommunications companies face, a Hartford spokeswoman said.
>
> "Then, days before the policy's Oct. 1 renewal, Hartford rescinded its renewal offer.
>
> "'We absolutely became unglued over that,' Mr. Buckley said."[43]
>
> Subsequently, Hartford offered to extend the coverage for 60 days for a prorated threefold premium increase. Mr. Buckley characterized that quote as "ridiculous and unconscionable."

Certainly, with this sort of gouging occurring in the market even for large risks, now is not the time to be deregulating commercial lines. The NAIC should table or reject this Model Bill.

[43] "Risk managers placing blame on insurers for renewal woes." BRADFORD and LENCKUS, National Underwriter Jan. 14, 2002

APPENDIX A: STOCK PRICE CHANGE OF TOP COMMERICAL INSURANCE COMPANIES FROM SEPRTMBER 10TH TO TODAY

	Commercial Writer	Stock Price on 9/10	Stock Price Now (Close1/18)
#1	AIG	$74.26	$79.50
#2	Zurich	25.40	23.10
#3	Travelers (Citicorp)	42.45	49.96
#4	CNA	27.69	28.04
#5	Liberty Mutual	NA	NA
#6	St. Paul	41.25	40.45
#7	Chubb	66.47	66.70
#1 BROKER	Marsh & McLennan	$87.00	$103.37*

- The average increase for the above insurance firms since 9/10: 2.6%.
- A 2.6% return over four months is an annual return rate of 7.8%.

** Increase for Marsh & McLennan, the largest commercial insurance agent/broker: +18.8%.*

Statement of

Alice D. Schroeder
Senior US Nonlife Equity Insurance Analyst
Morgan Stanley

before the

Subcommittee on Oversight and Investigations
of the House Financial Services Committee

Honorable Sue Kelly, Chairwoman

on

"How Much Are Americans at Risk Until Congress
Passes Terrorism Insurance Protection"

February 27, 2002

Statement of Alice D. Schroeder
Senior US Equity Nonlife Insurance Analyst, Morgan Stanley

Good afternoon, Chairwoman Kelly, ranking member Gutierrez, and members of the Committee. My name is Alice Schroeder, and I am the senior US non-life insurance equity research analyst for Morgan Stanley. I appreciate the opportunity to appear before you today. As an equity analyst, my research serves the needs of investors who buy insurance stocks. Therefore, my perspective is that of an observer of the industry.

I would like to cover four main points today:

- The landscape of risk – how the financial values that are exposed to terrorism are concentrated, and the extent to which they are being insured.
- The likely extent of economic disruption as available insurance capacity is exhausted.
- Responses to terrorism risk from the capital markets, including rating agencies and securities analysts.
- The adequacy of insurance capital to handle terrorism risk, and why insurance prices are rising.

The Landscape of Risk

Distribution of economic value. We started by reviewing the landscape of risk – where economic values exposed to terrorism are concentrated. You can roughly describe the risk as falling into the categories of "people" and "property."

- The risk associated with human lives obviously extends far beyond economic value. However, as a simple example, a proxy for the economic cost of a single life in New York, might be $550,000, which is the typical combined minimal life insurance and workers' compensation insurance paid to the victim's survivors. So an event claiming 1,000 lives might result in $1.5 billion or more of such direct costs, in addition to indirect costs to the economy. This estimate also excludes disability, liability, and other potential costs, which could be even more significant.

- The risk to property is widespread, including buildings, airplanes, other vehicles, cargo, inventory, equipment, homes valuable articles and other properties. As one simple measure, the value of total commercial property appears to be around $7.1 trillion, distributed among commercial banks, savings institutions, insurers, pension funds, and commercial businesses, and investment companies. We also believe there may be significant property exposures that are not captured by our data – for example, houses of worship, monuments and public buildings.

We have performed detailed estimates of the aggregate economic cost of larger terrorism events. This easily could reach the hundreds of billions or even trillions of dollars, excluding indirect impacts to the economy. While the risk of the larger events may be lower than smaller events, no one knows exactly what that risk *is*. Further, we believe that dealing with a large loss after the fact is likely to result in inequitable outcomes.

Finally, we believe the current state of uncertainty indirectly harms the economy by making businesses and individuals less able to plan. While many are hoping that the government would protect them after an attack, our discussions with businesses indicate that the uncertainty of that outcome creates a chilling effect on the economy.

Economic Disruption from Terrorism Risk

Response to terrorism has been to distribute the risk. We believe the risk of terrorism, which was formerly born largely by insurers, is now being distributed more broadly throughout the economy.

- **Property and business owners** are seeking insurance coverage, but not necessarily finding it, except for workers' compensation and life coverages, where it is statutorily mandated. Some insureds are buying extra coverage from the limited number of markets offering it. However, their insurance renews year-round, so many still have coverage. Those who do not appear to have varying levels of concern about their lack of coverage. Some are extremely concerned, especially owners of large real estate properties. Others appear to be assuming the risk of loss is low, or that they would be bailed out by the government. Those who have coverage appear to take for granted that their claims would be paid, although our analysis of the impact of state-mandated coverages on insurer solvency suggests this is not necessarily a safe assumption.
- **Lenders** have two exposures: real estate loans and loans secured by collateral that could be damaged by terrorism. Lenders' main exposure would be default risk relative to their capital bases. Lenders also have shown varying degrees of concern about lack of coverage in their portfolios, which appears to relate to their business mix. We understand that some lenders are requiring insurance, whereas others have begun to ask borrowers to explicitly self-insure for this risk. Still others are not enforcing insurance covenants and appear to be living with the risk.
- **Primary insurers** have generally concluded that the risk exposes them to potential insolvency. They appear to be taking a variety of steps to reduce this exposure: 1) nonrenewing coverage for "skyline assets" and other obviously exposed properties; 2) attempting to reduce the risk of large workers' compensation exposures by nonrenewing some customers; 3) excluding the risk from coverage, to the extent permitted by regulators; 4) gathering data to better assess exposures; 5) developing models to measure exposures; 6) selling insurance on a "nonadmitted" basis, which may permit coverage exclusions where they are otherwise not permitted. One insurer is reportedly planning to sue the state of California for not allowing exclusions, and exposing it to insolvency. We cannot quantify the degree of nonrenewals. However, insurers tell us that they generally are not assuming significant terrorism risk from "target properties," such as large urban risks and power plants, unless required to do so by regulators.

- In their role as risk aggregators, nearly all **reinsurers** appear to have chosen to exclude the risk, so that they can separately underwrite an amount of terrorism coverage that is reasonable relative to their capital bases.
- **State regulators** in key states (New York, Florida, California and potentially, Illinois) are mandating that insurers provide coverage. In the majority of industrial states, state laws require that fire following an act of terrorism must be covered. State laws also require that workers compensation and life insurance coverages include terrorism risk. Accordingly, customers by law are receiving some insurance protection, although the amount varies. To avoid assuming the risk, some insurers are using nonstandard policy forms which may not be subject to these laws.

Redistribution does not reduce risk. Mathematically, the efforts of customers and insurers collectively will not protect the economy against terrorism. The risk has only been redistributed among the various affected parties. In the process, we believe that some implicit assumptions might be made by some about what would happen if another terrorist attack occurred. These include the assumptions that 1) the federal government would provide essentially unlimited post-event funding; 2) such funding would be in proportion to economic losses incurred, regardless of insurance coverage; 3) any capital destroyed by the event, as well as debt such as insurance claims would be paid by the government; 4) the attack would be considered an act of war; and 5) terrorism exclusions imposed in "nonadmitted" policies would be upheld, if challenged in court. We do not believe these assumptions can necessarily be taken for granted.

Extent of economic disruption. We can identify at least four reasons why there has not been more evidence of economic disruption. First, insurance policies renew throughout the year, and many customers have not experienced 2002 renewals yet. Second, some exposed parties appear to be assessing their individual odds of being attacked as low, hoping for the best. Third, some exposed parties appear to be counting on Congress to pass a bill or provide post-event funding. Finally, insurers have shown more restraint than we expected in nonrenewing customers. We attribute this to fear of competition, fear of being downgraded by rating agencies, and a desire not to create friction with customers.

We believe it is important to separate economic disruption from panic behavior. Because exposed parties are using various coping strategies to minimize panic behavior, there has been a perception in some quarters that no economic disruption is occurring. **On the contrary, we believe that transfer of a significant risk from insurers to customers by definition is a meaningful economic disruption.**

Even if every exposed party assesses its own odds of loss as low, collectively, the risk remains in the economy. We commend the Congress for its efforts to address this issue, and encourage you to work toward closure.

Economic disruption may worsen. We believe the complaints about economic disruption may worsen. Many insurance policies have not yet renewed, and thus continue to cover terrorism, but that is temporary. Some limited insurance capacity also is available for terrorism. However, it appears this capacity is being used by customers whose policies renew early in the year. Although more capacity will likely be developed, we do not believe it will meet demand. Accordingly, customers whose renewals occur later are likely to find that capacity is exhausted.

Terrorism risk not underwritable yet. In general, we believe that insurers may be, in the aggregate, under-estimating risks from locations other than so-called "target" properties. While the individual odds of an attack on other properties may be low, in total, those odds may be much higher. To date, terrorists have not behaved predictably, and no study we have seen suggests that they will do so. We do not believe insurers have a reasonable basis for underwriting the risk at this time. At best, they can limit the amount of capital they expose to the risk. Although insurers are beginning to gather data, as indicated by former CIA Director Robert Gates in a recent speech, it may be at least five years before risk falls and experience rises to the level at which insurers can adequately underwrite terrorism.

Responses to Terrorism Risk in the Capital Markets

Rating agencies expressed concern, but have not downgraded: Rating agencies expressed concern about terrorism risk in the fall of 2001. In general, rating agencies commented on the potential rating threat, in the absence of legislation, to corporates, other bond issuers, and insurers. However, since the legislation failed to pass, rating agencies have not downgraded bond or debt issuers or insurers.

Regarding the approach to issuers, we believe the rating agencies are approaching this issue similarly to the way risk-bearing enterprises are viewing it. That is, they are assessing the risk for each issuer based on probabilities. Putting aside the lack of frequency data or other means to assess probabilities, the large number of potential targets of terrorism by itself ensures that, mathematically, the risk to most individual issuers can be described as low by rating agency standards. Accordingly, there appears to be an ironic outcome.

- Although there have been a number of instances since September 11 in which the federal government has declared a "high alert" for terrorism based on specific evidence of planned attacks, the collective impact on ratings of terrorism risk has been nil.

- Based on rating agency comments in the fall of 2001, we would have expected that at least some businesses that lack terrorism insurance would have been deemed high enough risk by rating agencies to warrant downgrades or negative outlooks. Likewise, we would have expected some action on insurer ratings.

- It may be that the rating agencies are waiting for Congress to act, or are continuing to analyze the situation. However, nearly 60 days into 2002, we are somewhat surprised to see no rating consequences from terrorism.

It would be disappointing if rating agencies analyzed terrorism risk as if it had no solvency consequences to any issuers. We believe that claims-paying and credit ratings are heavily relied on by investors and insurance buyers as an important signal of financial health. We believe there is the possibility of insolvencies due to terrorism; and rating agencies have acknowledged this risk.

Rating agencies have come under criticism recently for their role in certain business failures, especially the failure to act as an early warning system in the case of Enron. It is not our intention to add to this criticism. However, we believe it would be unfortunate if terrorism-related impairments occurred of entities without insurance against terrorism, or of insurers overexposed to terrorism, with no warning that those entities had exposure. This would be especially regrettable after the rating agencies made such a good start last fall analyzing terrorism risk.

Institutional investor concerns can be addressed through disclosure: Similar to the rating agencies, we have not seen a dramatic response by the capital markets to this risk. However, our conversations with institutional investors suggest that they generally are not pleased about the degree to which their capital is being used to assume large amounts of terrorism risk. We question whether companies would have the same risk tolerance if their managements were putting their own personal net worth at risk of terrorism.

The SEC is considering the extent to which lack of terrorism insurance should be disclosed by risk-bearing enterprises. We understand the difficult tradeoffs this entails. However, we believe that investors, as the company's owners, generally have a right to know this information.

We have reflected terrorism risk in our own stock ratings. We downgraded the whole sector in November in part due to this risk. We also generally are not recommending the stocks of commercial insurance companies that appear to have material terrorism exposures relative to their market capitalization. Some stocks that we are recommending do have exposure, but we have carefully selected our recommendations to try and protect investors as much as possible. To reduce this exposure further, we also are recommending that investors avoid concentrating in terrorism-exposed insurers beyond their own risk tolerance, since individual insurer exposure, loss frequency and loss severity are impossible for an analyst or investor to assess.

Insurance Capital Adequate to Handle Terrorism?

Some observers have suggested that insurers are overcapitalized. We have even seen terms such as "wealthy" used to describe the industry. Rather than relying on emotionally loaded rhetoric, we believe Congress should consider the facts.

- Since its peak in 1999, the capital of the US nonlife industry has declined by $58 billion, or 17%. This decline has come largely from the commercial lines companies.

- As a group, the commercial lines industry is producing more than $2 of premiums for every $1 of economic capital, a level at which there generally is considered to be **no** excess capital under regulatory and rating agency standards.

- Reflecting this level of capitalization, rating agencies have downgraded numerous insurers in the past two years, and at an accelerating pace. In addition, a number of insurers have failed or decided they cannot afford to continue in business, and others are fighting for survival. A few examples:

  - ➢ Major insurance failures include Reliance, HIH, Independence, Frontier, Taisei, and Superior National.

  - ➢ Several companies have decided to radically downsize or discontinue their principal businesses, including Highlands, Gainsco, and Industrial Risk Insurers, which was formerly the largest insurer of large engineered properties in the US.

  - ➢ A number of reinsurers, including Overseas Partners, Copenhagen Re, Scandinavian Re, and Fortress Re, have discontinued operations. Many others, such as CNA, Hartford, St. Paul, and W.R. Berkley, are downsizing their reinsurance operations significantly.

  - ➢ Rating agency actions continue to affect insurers. Legion, a major commercial insurer, was just downgraded to the single "B" level. The California State Compensation Fund, which is the largest workers' compensation insurer in the US with more than a 10% national market share, recently had its rating withdrawn by Standard & Poor's because it had fallen to such a low level. Other ratings remain on watch and subject to further action.

  - ➢ In our view, the majority of the capital raised in 2001 by insurers was in order to maintain ratings, because these companies had become undercapitalized.

In considering the insurance industry's capital to withstand terrorism risk, only the capital of the US *commercial lines* industry should be considered, which we estimate at approximately $125 billion. This compares to estimated terrorism exposure of $100 billion or more from a single event.

Why Insurance Prices are Rising

Finally, we address the reasons for insurance price increases.

Insurers produce poor returns. To an insurance investor, accusations of price-gouging and excess profits seem topsy-turvy. Nonlife insurers rarely earn their cost of capital. Insurance buyers typically receive very good value for their premiums, in our view, and periods of price adequacy are relatively rare. Over the past 10 years, US insurers have averaged an 8.5% return on surplus, falling to 7.4% from 1998-2000 and a loss in 2001. This is 7.6% - 10.2% worse than the average S&P 500 company, and equivalent to a corporate bond yield. Yet insurance equity investors take on considerably more risk than bond investors.

In addition, from our perspective, even these relatively low returns were provided by two factors largely outside of the industry's control. These were the unusually strong investment returns of the 1990s, and cost deflation experienced by insurers during this period. These factors enabled insurers to lower prices continually on virtually all products. Without these factors, insurers would have lost money during the entire decade of the 1990s.

Importantly, however, both of these trends have reversed. Investment returns have declined to more normal levels, and the industry is now grappling with significant cost inflation. The combined impact of low investment returns and high inflation is the most important reason for current insurance price increases, in our view.

Prices rising for many reasons. Insurance prices had been rising for approximately 18 months before September 11. While terrorism losses, terrorism risk and rising insurance prices have become linked in the public's mind, we believe this is misleading. Insurers seem to be pricing terrorism consistent with the way they generally price a new hazard that is extremely difficult to quantify and which could destroy large amounts of capital. The price has to be high enough to cover the insurers' almost complete lack of knowledge about the risk of loss.

In general, there are three basic factors that drive insurance pricing. These are the supply of capital willing to assume risk, the demand to transfer risk via insurance products, and the profitability of the business.

Insurance capital to assume terrorism risk. Insurance capital was diminishing before September 11. We estimate that roughly an additional $50 billion was destroyed by the terrorist attack. We estimate that more than $35 billion of losses have already been recognized by the industry. Part of this has not been reported in financial statements due to accounting devices such as finite reinsurance, which appear to have been extensively used, especially by non-US companies, to avoid reporting September 11 claims. In addition, insured losses from large catastrophes are virtually always underestimated in the initial months, and continue to increase over time. Accordingly, we do not believe that credible data supports a claim that the loss is lower than expected. We also believe it is unlikely that the loss could be only $35 billion, considering that known loss estimates including finite appears to already exceed this amount, and is likely to go higher.

It has been argued that new insurance capital raised since September 11 should protect the economy against terrorism. In addition to several start-up reinsurers, undercapitalized insurers have raised money to maintain their ratings, totaling more than $20 billion. However, this capital is not being used to take terrorism risk. Even if it were, $20 billion would not cover a fraction of the potential losses from terrorism.

Demand for protection against risk increasing. The second factor is the demand for risk transfer products. September 11 revealed that the risk was greater than previously assumed. Customers and insurers also recognized that financial exposures to terrorism needed to be measured differently. Customer exposures to terrorism in the hundreds of billions of dollars – or higher – may exist, most of which was previously covered by insurance. Finally, other loss events not related to terrorism, such as Enron claims, have indicated that both insurers and customers were assuming more risk than they contemplated. This has increased the demand for and price of coverage by causing both insurers and customers to become more risk-averse.

Insurers must raise prices to prevent more insolvencies. Finally, insurers have achieved unusually poor returns over the past four years due to underpricing. The industry reported estimated underwriting losses of $130 billion in total from 1998 to 2001. We expect these losses to grow over time as insurers recognize the impact of inflation, which does not appear to have been adequately understood at the time these numbers were reported. These losses have financially impaired a number of sizeable insurers. **Customers have gotten a bargain over the last few years, and some insurers have even been bankrupted in the process.** Now, prices have to rise to allow the remaining companies to cover their costs.

We appreciate the opportunity to provide you with information that we hope was useful. We would be pleased to answer any questions you may have.

CIAT COALITION TO INSURE AGAINST TERRORISM

STATEMENT BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE ON HOW MUCH ARE AMERICANS AT RISK UNTIL CONGRESS PASSES TERRORISM INSURANCE PROTECTION?

February 27, 2002

Madam Chairwoman and Ranking Member Gutierrez, we commend you for the much-needed attention that you, Chairman Oxley and Ranking Member LaFalce are bringing to this important issue by conducting this hearing. It is clear that Committee and Subcommittee Members recognize the importance of this issue and its impact on the U.S. economy. We thank you for your leadership in addressing insurance-related problems by passing H.R. 3210, and we also want to acknowledge efforts by the White House to remedy the terrorism insurance crisis.

The Coalition to Insure Against Terrorism represents a wide range of businesses and organizations that are concerned about the increasing exposure they face because of the absence of affordable and comprehensible terrorism insurance. The Coalition believes that this gap in coverage threatens economic progress and will lead to more jobs lost if the Congress does not remedy this problem.

More than ever, Americans are looking to our leaders to help secure our way of life. That is why the efforts of President Bush and Congress to strengthen our

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homeland security are so important. Yet all over America, a growing list of public and private companies and places are uninsured against terrorism. Ports, airports, buildings, businesses, tunnels, bridges, power plants, transmission lines, gas pipelines, sporting events, wholesale distributor facilities, and entertainment venues all are at risk.

At a time when President Bush, Attorney General Ashcroft, and CIA Director Tenet and others continue to warn America about possible — and even likely — attacks on places ranging from private facilities to famous landmarks, it is imperative that Congress act soon. Without the protection of terrorism insurance, a growing number of workers, businesses, facilities, and infrastructure are left uncovered against a potentially catastrophic loss. Although we remain vigilant against the next terrorist attack, the lack of terrorism insurance is an increasing threat to our economic security, and to our homeland security, as well.

Excerpts from the General Accounting Office report substantiate that the problem is growing worse by the day, resulting in more of the nation left uninsured or underinsured for the next terror attack. American businesses could face severe economic dislocation in the coming months if the Federal government does not immediately address insurance-related issues tied to terrorism. Absent adequate insurance, business models do not function well and many lenders will not lend. The impact will ripple through the economy to employees, vendors, suppliers, contractors and investors such as pension funds. New investment and economic growth will suffer, delaying the economic recovery and even threatening our economic security. Every business decision delayed or cancelled because of this lack of insurance means jobs lost or not created — construction jobs, building and trade jobs and others. Every sector of the economy will be affected, as the breadth of our membership demonstrates.

Without terrorism insurance coverage, businesses are forced to self-insure. This means committing and putting at risk capital that could otherwise be used for investment and job creation. Furthermore, financing for new construction and capital investment in many of our buildings, plants, ports and factories will dry up since lenders are no more willing to bear the risk of terrorism than are the insurance companies.

To continue to operate in the normal course of business, our members need to be insured for risks that have traditionally been insurable, including damage associated with terrorism. The insurance industry now is not providing terrorism coverage under general property and casualty policies (including crucial business interruption), and businesses can only obtain limited, deficient and possibly defective in coverage the current marketplace, and that at only exorbitant pricing. Those policies that are available don't even cover bioterrorism, a threat that Members of Congress are all too familiar with.

The unsettling reality is that since September 11th, we are experiencing an insurance market failure. Insurance companies will not sufficiently insure against the risk of terrorism — despite the demand for coverage. The magnitude of this failure is building as more and more insurance policies come up for renewal leaving an ever-increasing number of businesses unprotected from terrorist related losses. Unless the federal government intervenes, this could create havoc in the economy, threaten its recovery and pose a very real threat to our homeland security.

Given this insurance market failure, the Federal government appropriately can, and should, play a role in ensuring that policyholders can obtain coverage against any terrorist attack, including bio-terrorism. Individuals and companies should not bear the full brunt of the risk when the terrorists' real target is both the United States government and our society as a whole.

As you know, there is ample precedent for the Federal government filling the insurance or reinsurance gap: (1) crime and riot insurance programs were created for urban business owners following the social unrest of the late 1960s and early 1970s; (2) flood and crop failures are insured under Federally sponsored programs; (3) standby war risk coverage already exists for certain aviation and maritime operations (including a post-September 11 expansion of the aviation war risk program to cover terrorism); and (4) during World War II, the Government authorized a program, administered by private insurers, which insured property against "enemy attack." The last is a particularly good example of a short-term government program that restored business and consumer confidence during a wartime emergency but which closed down when normal conditions were restored.

The effects of lost insurance coverage on policyholders represented by our coalition are potentially severe. As one example, building owners and operators will be fully exposed to liability and property damage losses from terrorist attacks and will be powerless to do anything about it. Furthermore, without government action, our industries face the prospect of being held in default of loan covenants agreed to at the time financing was secured. Since operating a business without adequate insurance in many cases is not feasible, some businesses will confront the possibility of ceasing or limiting operations until insurance once again becomes available. Put simply, without Federal action the ability to finance, buy or sell many businesses across the nation is at risk.

In the face of continuing threats of terrorist attacks and mounting evidence of economic disruption, Congress must act soon. Without a federally-backed initiative, terror insurance is becoming an increasingly necessary and expensive product in very short supply. We urge Congress to make sure that Americans have access to affordable, comprehensive terrorism insurance. It is a crucial step to prevent further homeland in-security. And it is absolutely necessary to retain our great nation's strength and confidence. The Coalition also believes it is important to include in any terrorism insurance legislation Congresses passes reasonable limits on the liability of non-terrorists for damages caused by a certified act of terrorism, treating all businesses equally.

If you would like to discuss this important issue in greater detail, please contact Marty DePoy at the National Association of Real Estate Investment Trusts at (202) 739-9411, Kimberly Pinter at the National Association of Manufacturers at (202) 637-3071, or Joe Rubin at the U.S. Chamber of Commerce at (202) 463-5354.

NAIC

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February 27, 2002

Honorable Sue Kelly, Chair
Honorable Luis V. Gutierrez, Ranking Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Representatives Kelly and Gutierrez:

In conjunction with the Oversight Subcommittee's February 27th hearing on terrorism insurance problems, the National Association of Insurance Commissioners (NAIC) is providing you with the attached update of actions taken by state insurance departments to address the availability and affordability of terrorism insurance in the United States. We ask that you include this letter and the attached report as part of the Subcommittee's hearing record.

Last year, beginning with our testimony before this Committee on September 26th, the NAIC and state regulators were vocal supporters of the need for a limited federal program that would bring certainty to commercial insurance markets, thereby encouraging insurers and reinsurers to offer terrorism insurance protection to their customers. When Congress failed to enact legislation before the general policy renewal deadline of January 1, 2002, state insurance departments were forced to take appropriate regulatory actions to preserve the solvency and stability of the Nation's insurance industry. However, we continue to believe a short-term federal assistance program could serve the public by making it possible for commercial insurers to accept terrorism risk. The terrorism exposure is potentially catastrophic to consumers and industry. Currently, there is no good way for private insurance underwriters to measure or control the likelihood and costs of terrorism losses.

State insurance regulators share the widespread belief in Congress that affordable terrorism coverage should be available to American businesses. Our primary legal responsibility is to preserve the financial health of the insurance industry so that all policyholders get their claims paid. As regulators, we cannot jeopardize the solvency of insurers covering homes, automobiles, and established business risks in order to require that they cover terrorism risks that nobody – not even the federal government – can presently quantify with reasonable precision. Accepting measurable risks and spreading them at a fair price is fundamental to the business of insurance, but forcibly assigning non-quantifiable terrorism risks to private insurers at this time would, in our opinion, unwisely put the entire American insurance system at risk.

State regulators have addressed the terrorism insurance issue in two basic ways. First, we are closely monitoring the financial condition of the insurance industry to assure that it remains strong. Second, most state insurance departments have approved limited commercial property and casualty policy exclusions that permit business insurers to control their terrorism risk exposure for an event that results in more than $25 million of insured losses in the aggregate. We have basically refused to permit blanket exclusions in personal coverage for home, auto, and other personal lines of insurance. Moreover, recognizing the policy exclusions approved for commercial insurers do not offer the same market certainty as federal legislation, they are set to expire 15 days after the President of the United States signs an appropriate federal assistance program, if that should happen.

As a result of state regulatory actions and market dynamics, individual policyholders and most small and medium-sized businesses today have insurance coverage for acts of terrorism. We are also beginning to see improvement in the availability of terrorism insurance coverage for large and extra-risky businesses, although the prices are high. State regulators and the NAIC will continue to monitor and re-evaluate market conditions to see if additional actions are needed to protect consumers.

State insurance departments have made some difficult decisions in trying to balance the solvency requirements of insurers with the public need for terrorism insurance coverage. We waited as long as possible to see if Congress would enact a federal assistance program. When that did not happen by January 1, 2002, state regulators in 47 jurisdictions acted to approve limited, but necessary solvency protections for the industry by January 15, 2002. Consequently, the insurance markets in America have kept working smoothly for individuals and most businesses.

State insurance departments acted effectively and promptly to address a huge national problem when federal government assistance was not available. The state regulatory response in the aftermath of September 11th – gathering information, monitoring claims, assessing solvency risks, and alerting Congress to potential displacements in the market place – illustrates that the American system of insurance supervision is second to none in moving quickly to protect the interests of the insurance buying public.

The NAIC and its members look forward to continuing our coordination and cooperation with Congress and federal agencies on insurance issues.

Sincerely,

Therese M. Vaughan

Terri Vaughan
Commissioner of Insurance, Iowa
NAIC President

Cc: Honorable Michael G. Oxley, Chairman
Committee on Financial Services

Attachment

NAIC

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Revised February 27, 2002

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An Update of State Insurance Regulatory Actions Taken in Response to the Terrorist Attacks of September 11, 2001

Step 1 – Assessing the Immediate Financial Impact on America's Insurers

- Immediately following the terrorist attacks of September 11, 2001, the National Association of Insurance Commissioners (NAIC), through its Financial Analysis Working Group, began analyzing the impact on the financial position of affected insurers. Regulators focused particularly on those companies that were heavy writers of business in New York, New Jersey, and Connecticut. They identified and analyzed the financial resources of 20 primary insurance groups representing 150 property/casualty companies, 20 reinsurance groups representing about 50 U.S. and international reinsurance companies, and several Lloyd's of London syndicates. Together, these groups accounted for more than 90% of the estimated losses resulting from the terrorist attacks.

- State insurance regulators prepared and implemented financial impact surveys during the fourth quarter of 2001. These surveys asked a number of questions about the projected losses, assumptions in estimating losses, reinsurance arrangements, liquidity issues, market risk, and so forth. Based on the responses, the regulators concluded the losses were large, but manageable. No specific solvency concerns were identified during the initial evaluation; however, insurance regulators have continued to actively monitor the situation.

- State insurance regulators have also been looking carefully at insurer investments. The NAIC's financial database contains detailed information on insurer investment holdings, updated quarterly. This has enabled regulators to gauge the industry's asset exposure in sectors that were directly affected by the events of Sept. 11^{th}. Scenario testing was performed to evaluate market risks in the airline and transportation sectors, travel and insurance sectors, high-yield bond markets, and stock markets in general. Much of the market risk of the insurance industry is held by the life insurance sector. While regulators found some insurers to have heavy exposures in these holdings, overall the industry appears to be well diversified. Less than 100 of more than 4,800 companies included in the analysis had significant capital and surplus decreases under these scenarios.

Step 2 – Assuring the Future Ability of Insurers to Pay Claims

- Following September 11^{th}, the NAIC and its members commenced an ongoing dialog regarding possible language for commercial lines insurance policies that would exclude coverage for acts of terrorism. State insurance regulators agreed they would need to allow insurers to adopt terrorism exclusions for commercial lines if Congress failed to provide a federal financial backstop that limited insurer losses from future acts. Absent state action, the financial health and resources needed by the insurance industry to pay all types of claims could be imperiled by potential losses from terrorism that could cause insolvencies, yet could not be reasonably measured or predicted in advance.

- On December 21, 2001, the NAIC concluded that if Congress adjourned without enacting a federal backstop, the states should approve narrow commercial insurance policy exclusions for acts of terrorism. The specific recommendation was that this exclusion would apply if the aggregate insured losses exceeded $25 million for interrelated events within a 72-hour period. In addition, coverage for nuclear events caused by acts of terrorism would be excluded from the first dollar. Overt acts of biological or chemical terrorism would also be excluded from the first dollar. "Overt acts" mean acts of terrorism that actually involve or are carried out by disbursing biological agents or chemicals, or attacking a property with an intentional release of biological or chemical agents, as opposed to an incidental release of hazardous materials. In the case of liability insurance coverage, the exclusion would apply if 50 or more individuals were killed or severely injured during the event.

- The NAIC also recommended that state approval of commercial policy terrorism exclusions be "conditional." That is, the exclusions would be subject to withdrawal 15 working days after the President signs federal legislation, if permitted by state law. Thus, if the President were to sign into law a federal insurance backstop program covering acts of terrorism, 15 working days later insurers would no longer be permitted to use these exclusions. The 15-day period provides insurance regulators with an opportunity to assess any federal assistance legislation, and reconsider what actions, if any, might be appropriate regarding the use of terrorism exclusions.

- Shortly after the NAIC reached its recommendations, Congress adjourned without enacting a federal terrorism assistance program. The NAIC immediately kicked into high gear. A model bulletin was drafted that included an expedited approval process. The Insurance Services Office, Inc. (ISO), an organization representing more than 800 insurers, re-filed its proposed commercial policy exclusions according to the language agreed to by the NAIC membership. At the end of the first week in January 2002, 35 regulatory jurisdictions had approved the ISO filing. By January 17th, 47 jurisdictions had approved the ISO filing, including the District of Columbia and Puerto Rico. At the time of this update report, the ISO filing on terrorism exclusions is still under consideration in California, Georgia, Florida, New York, and Texas.

- State laws do not permit exclusions of coverage for acts of terrorism for workers' compensation insurance. Under a workers' compensation policy, the insurer agrees to pay what state law requires it to pay on behalf of an employer. Workers' compensation policies typically refer back to state statutes under a simple insuring agreement, and insurers pay the benefits that are required by such statutes. State laws do not provide for an insurer to assume only part of a workers' compensation exposure. Thus, insurers are required to cover all risks, and there is a continuing exposure to catastrophic loss for acts of terrorism in the workers' compensation line.

- In addition, 29 states have long standing laws based on the old New York 165 line fire policy. The result of this fire policy codification is that policies must continue to cover any ensuing fire that follows a terrorist act. Consequently, while an insurer can exclude the terrorist act itself from a policy, any ensuing fire must be covered in at least 29 states. At the World Trade Center, ensuing fire claims were a significant part of total losses.

- State insurance regulators have recently received policy filings from insurers asking to exclude coverage in personal lines for acts of terrorism. On January 29, 2002, the NAIC adopted a motion that effectively precludes the use of policy exclusions for personal lines. The motion reads: "It is the sense of the NAIC membership that terrorism exclusions are generally not necessary in personal lines property and casualty products to maintain a competitive market, and they may violate state law. However, we recognize that state laws vary in their authority and discretion. Further, there may be unique company circumstances that need to be considered in individual cases. We expect these cases to be limited."

- At the time of this report, the NAIC is still reviewing the possibility of implementing group life insurance exclusions. It is possible that a motion similar to that adopted for personal lines may be considered for group life insurance products.

Step 3 – Monitoring the Availability and Affordability of Commercial Terrorism Insurance

- The NAIC's Reinsurance Task Force held a public hearing in Washington, D.C. on January 17, 2002 to explore the facts behind widespread anecdotal reports of significant rate increases and availability issues – not just related to acts of terrorism, but across the board. The hearing included representatives from primary insurance companies, both property/casualty and life, as well as reinsurers, insurance brokers, reinsurance intermediaries, and financial analysts who spoke about what is occurring in the marketplace.

- Regulators knew some upward adjustments in pricing were already taking place prior to September 11th. The insurance industry has experienced underwriting losses in many lines of business during recent years, and it was clear there needed to be some price increases. State insurance departments were receiving rate increase filings in the range of 10% to 20%. That process appears to have accelerated since September 11th, particularly in November and December of 2001. While acts of terrorism play a role in these increases, it is likely that some rate changes would have taken place regardless of the tragedy.

- A confluence of several factors appears to be driving current insurance market conditions. First, there is a general increase in rates and tightened underwriting to correct for prior underpricing in some markets. Second, investment income results last year were poor and cannot be relied upon to offset poor underwriting results. Third, reinsurance costs have risen, sometimes substantially, and reinsurance coverage restrictions have been introduced. Finally, the loss of capital from the events of September 11 and the continuing terrorism threat have likely exacerbated underlying market conditions. It is difficult to separate the impact of the September 11th terrorism events from the other underlying conditions that are driving market change.

- During the January 17, 2002 hearing, state insurance regulators heard that different markets are being affected differently. In the markets for small commercial and homeowners insurance, coverage for acts of terrorism is still available; it appears, unless there is a serious terrorism exposure for a specific risk. Rate increases tend to be in the 10% to 30% range. In the middle market, there are larger increases in some areas for lines or classes of business that have experienced significant losses. Exclusions for acts of terrorism are more common in the middle market, but are by no means universal. In the large market – the Fortune 1000 companies --capacity problems have developed. These problems are driving even larger price increases, and policy exclusions for acts of terrorism in that market are essentially universal. A separate terrorism insurance market has developed where companies can get some amount of coverage up to approximately $300 million, but the rates are fairly substantial.

- Reinsurance rates are going up significantly, particularly in property catastrophe and workers' compensation insurance. Insurers are much more concerned about the concentration of risk that exists in workers' compensation in light of the fact that they cannot exclude terrorism from workers' compensation policies. For example, insurers are looking at how many employees are located at one site, as well as the site's proximity to a potential terrorist target location. Risk concentration has become a significant concern in the underwriting process.

- Since September 11th, the market has experienced some reduction in available capital, although there have been several significant capital commitments, particularly in the reinsurance industry. Primary insurers now have limited exclusions available to them for acts of terrorism, although the exclusions do not eliminate the terrorism exposure in workers compensation or, in many states, for fire ensuing. This is not an ideal solution as many American businesses are exposed to significant potential losses for acts of terrorism for which they cannot obtain insurance protection. Small or weakly-capitalized insurers are also at risk. A single terrorism event causing $25 million in aggregate loss primarily to their policyholders could put the survival of the entire entity at stake. Thus, the present situation, which can more accurately be described as a Band-Aid rather than a viable solution, remains a significant cause for concern.

- The threat of terrorism hovers like a cloud over the insurance industry. It has caused insurers to be much more careful in how they underwrite and accept risk. They are being very careful in their underwriting process, and the results are appearing sometimes as rate increases and other times as a coverage availability issue. The terrorism threat arising from the events of September 11th is exacerbating some underlying market dynamics that would have existed in any event. The good news is that capital is coming into the industry in a rapid pace, particularly into the reinsurance sector. This should help ease the capacity problem and some of the market disruptions that are occurring.

- Today's changing market conditions should be viewed as an evolution rather than a revolution. All insurance contracts did not change on January 1, 2002. While many reinsurance policies have a common January 1st effective date, most primary insurance policies do not. For an individual policyholder, the problem of terrorism exclusions will not arise until it is time to renew their policy. Thus, this is a problem that will continue to emerge over time. Further, many businesses may not be cognizant of this insurance coverage issue, unless there is a major terrorist event causing insured losses that exceed $25 million. If that threshold is not pierced, it may seem as if things are proceeding as if it were business as usual. Another major event, however, may cause severe economic disruptions, due to the probability that some businesses will have terrorism coverage while others will not.

NMHC National Multi Housing Council — National Apartment Association

STATEMENT OF BRUCE C. STROHM,

EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL, AND CORPORATE SECRETARY

EQUITY RESIDENTIAL PROPERTIES TRUST

PRESENTED TO THE HOUSE FINANCIAL SERVICES COMMITTEE

OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE

CONCERNING

THE FEDERAL ROLE IN INSURING AGAINST ACTS OF TERRORISM

WEDNESDAY, FEBRUARY 27, 2002

The American apartment industry...working together for quality, accessible, affordable housing.

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My name is Bruce Strohm, Executive Vice President and General Counsel of Equity Residential Properties Trust, a publicly held apartment company headquartered in Chicago[1], and the largest apartment owner in America. It is my pleasure to submit this written testimony on behalf of the National Multi Housing Council/National Apartment Association's (NMHC/NAA) Joint Legislative Program. The National Multi Housing Council and the National Apartment Association represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management, and finance.[2] NMHC/NAA are a member of the Coalition to Insure Against Terrorism (CIAT).

The multifamily rental housing industry is a major part of American society. Nearly one-third of all American families rent their homes (whether apartment or single family homes) and one in five Americans live in an apartment. Rental revenues from apartments total almost $100 billion annually, and management and operation of apartments are responsible for approximately 500,000 jobs. According to the Small Business Administration, 98% of the companies that comprise the apartment industry are small businesses – many of them are family-run.

This statement will focus on five key points relevant to the apartment industry and the families it represents.

1. Terrorism insurance coverage can only be obtained for non-trophy properties for *unreasonably* low amounts of coverage for *unreasonably* high prices.

Equity Residential is currently closely reviewing available terrorist coverage options as part of our annual insurance renewal. Insurance experts informed us that the most likely amount of terrorism coverage available will cover only about 1% of our firm's total property value. This small percentage of insured property values is typical of large property owners, and may even be broader coverage than most commercial real estate owners enjoy, given the relatively lower risk exposure presented by Equity Residential's predominantly suburban assets.

The anticipated terrorist coverage is also very narrowly drafted. It would not cover attacks by foreign nationals operating on behalf of a foreign government, such as individuals linked to the "axis of evil" identified by President Bush. It would not cover bioterrorist attacks such as anthrax. It would not cover business interruption arising from government emergency closure of a property in the area of a terrorist attack, nor would it

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[1] A member of the S&P 500, Equity Residential owns more than 1,000 properties in 36 states with over 214,000 apartment units. Over one million Americans every year live in Equity apartments. In 2001, Equity Residential was named one of America's most admired companies by Fortune magazine.

[2] The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is comprised of 155 affiliates and represents more than 30,000 professionals who own and manage more than 4.5 million apartments. NMHC and NAA jointly operate a federal legislative program and provide a unified voice for the private apartment industry.

cover lost business income arising from the closure of a property to prevent future terrorist attacks.[3]

The terrorist coverage being offered in the marketplace is remarkably expensive, especially as there is no actuarial science to determine when and where acts of terror will occur next. Rates typically range from 3-7% of the value of the properties being covered with a total exclusion from coverage of any so-called "trophy" properties that may be more likely to be attacked. A typical premium for $100 million of non-trophy properties may range from $3-7 million. This cost is approximately 100 times the normal cost of property insurance.

Requiring narrowly drafted coverage for some acts of terrorism at rates approaching 100 times the normal cost of property insurance does not appear to me to be "commercially reasonable." At least one court has reached the same conclusion.[4]

Our firm's ongoing search for effective, affordable coverage for acts of terror confirms for me that resident quality of life and the availability of housing at affordable rents would be significantly affected if apartment firms are required to carry the expensive but narrow terrorism insurance coverage now available in the market.

To ensure the continued availability of affordable rental housing, capital markets' flexibility and federal government involvement are needed. Equity Residential and NMHC/NAA believe apartment firms should not be required to buy terrorist insurance coverage, which many mortgage lenders (with over $500 billion in multifamily mortgage credit outstanding) are demanding. Instead, housing providers should have the flexibility to take alternative approaches in coverage against terrorist risk, including going without coverage at some level, as firms typically do for acts of war.

But flexibility by capital markets and government agencies toward terrorism coverage on its own is not sufficient. Given the state of the market we have recently experienced, we believe that federal government funding is also needed to ensure that the supply of terrorism coverage for rental housing is adequate in scope as well as fair in price.

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[3] The issue of insurance coverage for costs arising from emergency closures is one of many still being disputed by insurance companies and their insureds after the closure of Reagan National Airport following September 11. Wall Street Journal, February 19, 2002.

[4] A judge in Hennepin County District Court in Minneapolis granted the owner of the Mall of America a temporary restraining order last week to prevent a lender from forcing the mall to buy a separate terrorism insurance policy as a condition of its lending agreement. The mall's owner said the lender was able to find limited terrorism coverage for the mall but that the coverage was inadequate and expensive, costing three times what the owner pays for all property insurance on the mall. That amount would be "a commercially unreasonable sum, which will only increase the financial burden on the mall's tenants, many of whom are small business owners," the owner said. "Insuring Against Terror Costly: Mall of America Feels Repercussions," The Washington Post, February 26, 2002, E1.

We believe the better policy is to have the American public – not a smaller group of ratepayers – assume the risk of terrorist attacks. Other countries at risk for terrorism have already adopted this practice. Particularly in a time of war, when Secretary of Defense Rumsfeld and the American public feel that another terrorist attack is likely, we should join those countries that protect their consumers and businesses with a national terrorism insurance program.

2. Both apartment owners and renters will be adversely affected by the failure to enact federal subsidies covering acts of terrorism.

Even before the horrible events of September 11th, apartment owners began to experience rate increases on property and general liability coverage of 50% to 100%. The extra costs of terrorism insurance, most of which is demanded by mortgage lenders, will severely impact apartment owners and result in increased rents to renters. In absolute terms, coverage costs in 2001 reached levels not seen in more than a decade. For example, one Florida property NMHC/NAA are familiar with is experiencing annual insurance costs totaling over $720 per unit, not including the extra costs of terrorism coverage. That is some $60 per month in operating costs, or a remarkable 10% of rental revenues on one property! As a percentage of revenues, insurance costs for the industry's leading apartment owners of 2.5% to 3% of revenues on a total cost of risk basis are more typical today. Translated into a per-unit basis, total insurance costs for these leading apartment owners can be as high as $250-$300 per year – $20-$25 per month in higher rent – on a property with $888 monthly rents, about the industry mean. Anecdotally, we understand that owners of smaller portfolios, including many rent-restricted, affordable housing portfolios, may be experiencing significantly higher rates than that.

How are rental housing providers responding? To mitigate the impact of insurance increases on the rents our residents pay, long before September 11, Equity Residential and many apartment firms were implementing enhanced risk management programs and taking higher deductibles. Renter's insurance and stronger risk management audits are some of the key components found in many firms' risk prevention programs, including Equity Residential. Tighter risk management programs only go so far, however, and so the largest and best-run apartment providers are managing the new market reality by taking higher deductibles. The $5,000-per-occurrence property deductible that was common as recently as a year ago is a thing of the past today for many firms. Instead, deductibles have jumped 500% and more at some of the best-run firms.

Smaller housing providers, unfortunately, lack the financial capacity of larger firms to assume higher deductibles. They also have less flexibility in negotiating better rates and coverage from their insurers. Finally, these smaller firms have less negotiating leverage with their lenders. As a result, these smaller firms must pass along a greater portion of higher insurance rates to these residents in the form of higher rents. All three factors have special implications for the cost and availability of affordable housing. Since the country's affordable housing is predominantly delivered by small business apartment owners, special attention is needed to ensure that insurance requirements set by the Department of Housing and Urban Development (HUD) and capital markets do not require apartment owners to insure against terrorist risks that are very remote at best.

3. A federal terrorism insurance solution should provide real relief for renters and small business apartment owners alike.

Recognizing that the legislative year is short and that a great deal of work was accomplished late last year to resolve key differences, we believe that remaining disputes should be resolved as quickly as possible so that legislation can move to conference. We are concerned that disagreements have been a major reason why, as one ratings agency recently wrote, it is "increasingly unlikely that meaningful reform will emerge at the federal level."[5] Substantive disagreements can be resolved - they should not be grounds for failing to move legislation to conference.

We commend the House Financial Services Committee for moving helpful legislation through the House of Representatives. We strongly encourage the Senate to bring consensus legislation to the floor for debate, up or down votes on the litigation management and other controversial provisions, and a motion to go to conference to resolve key differences between the House and Senate bills.

4. To ensure the continued availability of affordable housing at affordable rents, HUD should update its insurance requirements.

In the absence of Congressional action, the market is not standing still. However, greater attention is needed from HUD to address the impact of the changed market for multifamily insurance on affordable housing operating costs and the provision of housing at affordable rents.

To their credit, Fannie Mae and Freddie Mac appear to be listening to the apartment and commercial insurance markets closely. These firms realize insurance markets for multifamily collateral have changed significantly since early 2001. In response, they have updated key insurance requirements for deductibles and underwriter ratings on new and existing debt to ensure that insurance requirements reflect current market realities. Without this leadership and proactive response, smaller-portfolio owners and owners of rural, affordable apartment housing in particular would have no real choice among underwriters. Thanks to the agencies' response, renters of agency-funded affordable properties are not paying needlessly high rents for over-insured properties.

HUD continues to study the issue some months after hearing from and subsequently meeting with a broad coalition of industry housing groups. Absent additional guidance from the agency, some HUD-insured lenders have begun to force-place narrow, expensive terrorism coverage on aging HUD-insured properties in areas not generally considered to be at risk of terrorist attack. If courts have found force-placing on large commercial shopping malls to be commercially unreasonable, then the case against force-placing terror coverage on older, rent-restricted properties well outside of central business districts would appear to be even stronger. Limited operating funds should not go to needlessly over-insure against very remote terrorist risks.

As a result of this force-placing, apartment renters in affordable properties are paying higher-than-necessary rents because insurance requirements on HUD-insured loans

[5] Moody's Special Comment, "Insurers Face the Challenge of a Post September 11th World, January 2002, 5.

have not been updated to reflect new market norms. Force-placing terrorist coverage significantly drives up the cost of operating affordable properties and provides minimal benefit. When force-placed terrorist coverage is added to existing 100% rate increases, the availability of affordable housing is threatened.

HUD does not need to wait for Congressional action to provide the relief HUD-insured renters and owners need from the costs of terror insurance. Instead of permitting lenders to force-place terror coverage pending HUD clarification, HUD should immediately provide guidance to its mortgagees and participating owners to make clear that the absence of terrorism coverage does not constitute technical default on HUD-insured loans. HUD should also commence a study of the state of the property and general liability insurance markets for affordable housing and report its results to the general public. This information will further afford the opportunity for Congress and industry together to intelligently address the availability of affordable housing in light of today's increased terrorist risks.

5. Exorbitant insurance costs will decrease the building of affordable housing, severely impacting renters and construction jobs.

Construction of apartment communities has added roughly 250,000 new apartment homes in each of the past three years. The value of the new construction has averaged more than $17 billion annually, providing jobs to more than 200,000 workers.

In addition, apartment demand is rising as a result of changing demographics. Recent data support the notion that an increasing number of households now prefer apartment living, even though they could afford to buy a home. Fully 41 percent of renters surveyed in the 2001 Fannie Mae National Housing Survey say they rent "as a matter of choice" and not out of necessity. This is up significantly from 32 percent in 2000 and 28 percent in 1999.[6]

The important apartment market of under-30 households will grow by half a million between 2000-2005 and another million from 2006-2010. This is a marked change from the 1990s, when this group fell more than 1.6 million. At the other end of the spectrum, the Census Bureau says the number of "empty-nest" households (married couples at least 45 years of age without children in the home) will increase over 5 million by 2010. While most will be homeowners, many will choose apartment living for its convenience, location, and social opportunities. Finally, immigration continues to expand, and new immigrants are predominately renters. The 1990s saw the second largest wave of immigration ever, and the current decade should surpass it.

An increasing population, decreases in new apartment buildings, and exorbitant insurance premiums are a recipe for higher rents and operating costs for apartment renters and owners alike.

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[6] New Data Suggest Apartment Living Is Becoming More Popular: "Renter By Choice" Households Growing, Aug. 29, 2001, NMHC Release, http://www.nmhc.org/Content/ServeContent.cfm?IssueID=10&ContentItemID=1007.

In conclusion, higher rents and small business operating costs, resulting from a thin market for commercial insurance for acts of terrorism, are real. We commend this committee and its leadership for seizing the opportunity to advance the debate by moving this important legislation through the House of Representatives. We encourage the Senate to proceed soon with up-or-down votes on the few, but significant differences, and bring its approach to conference. Surely we do not need to wait for another attack to occur before Congress acts.

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Statement of Edward C. Sullivan
President
Building and Construction Trades Department
AFL-CIO

Committee On Financial Services
Oversight and Investigations Subcommittee
February 27, 2002

Madame Chairwoman and Members of the Subcommittee, on behalf of the 3 million men and women of America's building and construction trade unions, I appreciate the opportunity to express our strong support for the prompt enactment of federal terrorism insurance legislation. The unavailability of terrorism insurance is hurting the construction industry by making the cost and risk of undertaking new building projects prohibitive.

There is growing evidence that this crisis is real.

Just last week Reuters reported that " If you are a developer looking for money to finance construction of a big office building or you need to refinance a mortgage for a well-known commercial tower, chances are you will have a tougher time getting that loan. And if you do get the cash, you'll pay more because borrowing costs have risen in the wake of Sept. 11 due to uncertainty related to terrorism insurances."

And on February 18^{th}, the CEO of GMAC Commercial Holding Corp. in Horsham, PA said, "This company will not do any significant construction loans without a terrorism policy that would cover the term of the loan...so at a minimum, unless you come in with terrorism coverage, I'm not in the construction lending business anymore."

Madame Chairwoman, these instances are repeating themselves across the country in every state in the Union. The manifestation is not immediate but the threat is insidious and pervasive. There is no doubt that if the lenders catch a cold in February, that the construction and building trades will have pneumonia by summer.

Every day that goes by between now and the time Congress completes action on terrorism insurance legislation presents an increasing threat to our members whose livelihood is dependent upon a robust and healthy atmosphere for building and construction. Every day that goes by without a federal terrorism insurance law on the books presents a serious and escalating threat to the building and construction industry as a whole, and likely to downstream industries like suppliers. This translates into a threat to our economy and a loss of jobs for our members. But a federal backstop for terrorism insurance can do away with both of these threats. It is a simple as that.

We commend you and your colleagues on the House Financial Services Committee for your leadership and for responding so promptly in reporting out a terrorism insurance bill which passed the House late last year. Although legislation has passed the House, it has stalled in the Senate. I would like to use this opportunity today to report to you that I have joined with Steve Bartlett, President of the Financial Services Roundtable, in sending letters to President Bush and Senators Daschle and Lott, among other senators, urging the Senate to move forward expeditiously to complete whatever actions are necessary to finalize this legislative effort. A copy of the letter is attached to my statement.

As this subcommittee well knows, the availability of terrorism reinsurance essentially evaporated after the September 11 terrorist attacks. Without reinsurance, insurers are unable to spread the risk of their policyholders' losses. If insurers cannot spread risk through reinsurance, they cannot accept risk from their policyholders. What this means in the real world is a dramatic contraction in the availability of insurance and a dramatic impact on the cost of insurance, when it is available. The purpose of the federal legislation is to provide a federal reinsurance backstop for a short period of time, until the private reinsurance market recovers, thus making insurance available again. Under the legislation – both H.R. 3210 and the Senate version -- if no major terrorist events occur, the federal government incurs no expense.

This reinsurance availability crisis is particularly critical for the construction industry, especially that part of the industry engaged in the construction of major commercial facilities and large structures. All of us know from September 11 that the terrorists are aiming at America's infrastructure. Because of that, building projects are being delayed or cancelled. Lenders are refusing to go forward with previously planned projects where terrorism insurance coverage is no longer available. And construction workers -- our members -- are losing job opportunities. As Mr. Bartlett and I noted in our letters:

> The lack of insurance has had a chilling effect on lending for large commercial construction projects, and though the breadth of the negative impact may not be fully evident, there is no doubt that lenders' are steering money away from projects that lack insurance... (O)nce the insurance problem is imbedded in the economy, the deleterious impact on growth will be difficult to reverse.

The evidence of economic impact is all around us. It may not be quite as dramatic as bricks suddenly falling off of buildings; but it is becoming more and more dramatic as we see the bricks that are sitting idle and not being used for new construction, because construction projects throughout our country are being put on hold. This market disruption is a particular threat in high-risk geographic areas and for projects that can be perceived as high profile or high-risk -- stadiums, office towers, airports, subways, shopping malls, resorts, universities, theme parks, power plants, railroads, and hospitals.

Madame Chairwoman, I am aware that there are some who sincerely believe that there is not a crisis. I would caution those who believe this, that they misunderstand the nature of the crisis. The reason that the insurance mechanism has not imploded is that in many states, the insurance commissioners have allowed insurers to exclude terrorism losses from their commercial insurance policies. This action will certainly help the insurance mechanism from collapsing, but what it really does is to transfer the risk of a terrorist event back to the policyholders. In reality, this means that if there is another awful terrorist event, there will be no insurance, or inadequate insurance, to cover it. So what this means to real estate developers is that they will simply not build their buildings. Even if they wanted to – if they wanted to shoulder all of the risk -- they in all likelihood could not secure the financing.

For those of us who represent America's workers, economic disruption is not some sterile statistical concept. To us it means jobs – and as I said in the beginning of my statement, it is as simple as that. Economic disruption means jobs lost, communities diminished, and families disrupted.

In the aftermath of September 11 many of the brave men and women who are doing the dangerous work clearing the World Trade Center site and making it safe again are members of our unions. They continue to work incredibly long hours, coping with emotional and physical challenges unimaginable to most of us. These terrorist acts are not targeted at insurance companies, commercial lenders, real estate developers or unions; the target is America and her most recognizable symbols. During a time when our political leaders remind us daily of impending threats, it makes sense that the federal government would fill the breech left by the natural flight of some reinusureres.

Madame Chairwoman, enacting terrorism insurance backstop legislation is too important to be derailed by partisan arguments. Thus, differences on issues not at the core of the legislation -- but holding-up Senate action -- should be resolved through good faith compromise. Organized labor and the business community have come together to jointly urge the Congress to move forward promptly with this legislation. This is powerful evidence that action is needed and that normal differences should be put aside in light of the extraordinary circumstances that have caused the need for this legislation. The continuing health of our economy depends on it. The livelihoods of millions of American workers and their families that extend way beyond the membership of our union depend on it.

Our members would like to have the opportunity to continue to work, to build and to support their families. The prompt adoption of terrorism insurance by the Congress can make this possible and can save our economy from serious consequences that are beginning to occur already because this legislation is not yet in place. We strongly urge you to continue your efforts to get this job done and we, again, commend you and your committee for all your are doing to help us realize this goal.